HOULIHAN LOKEY

Let Knowledge and Experience Navigate

BUYING AND SELLING THE TROUBLED COMPANY

HOULIHAN LOKEY

HL.com

Distressedmanda.com

Dear Reader,

Houlihan Lokey is pleased to present to you its Third Edition of *Buying and Selling the Troubled Company.*

During the 15 years or so since Houlihan Lokey's initial publication of *Buying and Selling the Troubled Company*, the number and size of distressed company M&A transactions have continued to grow at a rapid pace. In addition, major evolution in the capital markets has impacted the complexity of corporate financial structures. This, in turn, has affected the strategy and process of selling the troubled company, a result, among other things, of the growth in the number of participants involved.

This introductory case study is designed to provide those unfamiliar with this unique deal environment with answers to the following basic questions:

- When is the sale of a company an effective response to its financial distress?
- How does distressed company valuation differ from a similar process for a healthy company?
- How is the distressed company sale process best implemented?
- What issues can arise in effectuating a distressed sale transaction?
- What are the goals of the distressed company and its Board of Directors, secured and unsecured lenders, trade creditors, shareholders and prospective buyers?
- When is a bankruptcy filing properly employed to effectuate a distressed company transaction?
- What strategies can the interested parties utilize to best achieve their respective goals in a complex, time-sensitive situation?

This case study has been structured to provide the reader with an overview of a relatively simple distressed company M&A process from start to finish. While much of the content is devoted to illustrating the evolution of the subject company's fate, we have also endeavored to craft several substantive stand-alone sections that provide a quick reference resource for shareholders, purchasers, management, lawyers, lenders and others who have neither the time, nor the inclination to review the entire case study. These general sections include:

- Company's Options and Strategy
- Bank's Options and Strategy
- Retention of an Investment Banker

- Adjusting and Forecasting Financial Information
- Distressed Company Valuation
- The Troubled Company Sale Process and Strategies to Help Maximize Value

Summary Background to the Case Study

Our case study addresses the questions aforementioned by observing the trials and tribulations of "RuffCo," a fictional manufacturer of golf equipment.

Founded in 1990, RuffCo, Inc. ("RuffCo" or the "Company") enjoyed consistent growth and profitability by selling a well-designed and popular line of fairway woods. At the end of 2007 (almost 20 years after it was founded), RuffCo acquired "Peter Putter" and, encouraged by the stock market's excitement for golf club manufacturers and RuffCo's consolidation strategy, the Company went public. Unfortunately, a series of mishaps—including ill-timed product introductions, cost overruns and decreased demand resulting from the credit crisis of 2008 and subsequent recession—caused a "spiral of distress" that eroded the Company's liquidity and its bank's confidence in the Company.

Early in 2011, facing a significant over-advance on its revolving credit facility and "unrealistic" management expectations, the bank called a pivotal meeting that caused both the Company and the bank to explore their respective strategic options. The decision process resulted in the divestiture of the Peter Putter, Inc. subsidiary and, ultimately, the sale of the remainder of the Company.

The hypothetical sales process outlined herein is not intended to represent the only possible outcome for a company like RuffCo. As parties to distressed situations are well aware, the personal incentives and personalities of the participants will often have a substantial impact on a restructuring or sales process. A variety of other factors may make the simplified, general guidance provided by this fictional situation wholly inapplicable to a seemingly similar deal. The ideas and strategies discussed herein do not represent the institutional views of Houlihan Lokey and, given the difficult circumstances which may arise in distressed situations, may not be utilized for any purpose in connection with any litigated matter. We hope you enjoy these materials and the ideas expressed herein, and we welcome your questions, comments and perspectives.

While we believe that this case study presents detailed, easy-to-understand explanations and illustrations, the materials assume a basic knowledge of bankruptcy, finance and M&A transactions. The original case study was

created and written by Andrew Miller, P. Eric Siegert and Jeffrey Werbalowsky. This third edition was revised and rewritten by Andrew Miller, with the assistance of Peter Fishman and Brad Meyer.

We also appreciate the valuable artistic and design assistance of Chin Ong and Liz Hamm, and the editorial and marketing assistance of Andreea Popa and Robin Parrish, who helped make our vision a reality.

We hope you both enjoy and find useful this introduction to a fascinating and unique deal environment. Many deals in the current environment are more complex than our simplified case study. However, we believe that the basic principles illustrated here will assist you in your understanding of similar, but more complex, situations. Please feel free to contact us when you confront such situations, or to discuss particular issues. We look forward to the opportunity of working with you on your real world issues in distressed M&A and in financial restructuring in general.

Should you have any questions regarding this presentation, or if you would like to explore specific issues related to distressed M&A, or financial restructuring in general, please contact the authors or call one of our offices listed below.

Sincerely,

Andrew B. Miller
National Director
Distressed Company M&A

Houlihan Lokey
Los Angeles, California

LOS ANGELES
NEW YORK
CHICAGO
SAN FRANCISCO
MINNEAPOLIS
WASHINGTON, D.C.
DALLAS
ATLANTA
LONDON
PARIS
FRANKFURT
HONG KONG
TOKYO
BEIJING

© 1995, 1999, 2001, 2002, 2011 by Houlihan Lokey, Inc. All rights reserved.

TABLE OF CONTENTS

Background 1

The Spiral of Distress 7

The Bank Meeting 12

Company's Options and Strategy 13

Bank's Options and Strategy 18

The Negotiated Action Plan 21

Sale of the Company—Getting Started 24

Distressed Company Valuation and Application to RuffCo Golf 28

The Troubled Company Sale Process 37

Sale of RuffCo Golf 44

BACKGROUND

Overview

RuffCo, Inc. ("RuffCo" or the "Company"), a Delaware corporation based in Los Angeles, California, designs, manufactures and sells golf clubs. RuffCo was founded in 1990 by Charles Ruff, a local golf professional and renowned trick-shot artist with two children, Charles Junior (known simply as "Son") and Daughter. Charles Senior ("Father"), who claims an 8 handicap, is now 62 years old and oversees nearly all aspects of daily operations. Son, a recent business school graduate with a 2 handicap, heads the Company's sales and marketing function. The corporation is family-owned: 75% by Father and 12.5% each by Son and Daughter (who, preferring tennis to golf, plays no active management role in the Company). An old family friend, Frank Numbers, is the Company's CFO and Controller, but owns no equity in RuffCo. The Board consists of Father (Chairman), Son, Daughter, Numbers and one outside director, John Moneybags. Moneybags, who sports a 7 handicap, is a former senior official at the bank (the "Bank") where RuffCo has its asset-based debt facilities.

RuffCo distributes its products, principally fairway woods, through a network of more than 25 distributors across the U.S. and Japan. RuffCo buys raw materials (e.g., titanium and other metals) and component parts (e.g., shafts and grips) from select high-quality vendors. The Company's distributors sell RuffCo's products to both on- and off-course golf shops and select sporting goods retailers.

Business Description and Historical Results

RuffCo prides itself on its bootstrap beginnings: Father was teaching golf at a local public course and spent his free hours designing a club head with a shallower, harder face and lower center of gravity. This combination produced a fairway wood that allowed the weekend golfer to hit longer, more consistent shots out of the rough. The design also produced higher, straighter shots from the fairway. After conferring with local engineers and patenting the essential design aspects, Father made several dozen test samples of his new club, called the "Ruffhouser," and started selling the clubs door-to-door at local golf clubs out of the trunk of his car. From these beginnings, the Company's reputation and sales grew, not from heavy advertising or professional sponsorship, but by word-of-mouth among professionals and players at the local clubs Father had visited and revisited many times.

Despite its $250-plus price tag, the Ruffhouser line of fairway woods was well-positioned by the Company and its advertisers as "the working man's clubs for the guy in the rough." The line enjoyed huge popularity at public courses, pro shops and regional specialty stores. Ruffhouser, however, faced problems in larger retail golf outlets because the stores were reluctant to give the relative niche product (fairway woods) much shelf space in favor of companies that provided full sets of clubs.

During the 1990s and early 2000s the popularity of golf surged and Father sought to capitalize on the trend. Father expanded his scope from Southern California across the country by entering into exclusive distributorship agreements with golf club distributors that sold clubs to on- and off-course pro shops. Like many other club manufacturers, the Company experienced strong annual growth in sales and profitability. By 2007, the Company had grown from its humble beginnings to an expected $130 million in annual sales.

Table 1

RUFFCO HISTORICAL FINANCIAL RESULTS *($ in Millions)*

	2005A	2006A	2007E
Revenue	$74.3	$104.0	$130.0
Growth	*50.0%*	*40.0%*	*25.0%*
Cost of goods sold	43.3	61.0	77.0
Gross Profit	31.0	43.0	53.0
Gross Margin	*41.7%*	*41.3%*	*40.8%*
SG&A	22.6	31.0	39.2
EBIT	8.4	12.0	13.8
Interest expense	1.0	3.8	5.0
Pretax Income	7.4	8.2	8.8
Tax 40%	3.0	3.2	3.6
Net income	$4.4	$5.0	$5.2
EBIT	$8.4	$12.0	$13.8
Manufacturing depreciation	2.8	4.4	6.2
EBITDA	$11.2	$16.4	$20.0
% Margin	*15.1%*	*15.8%*	*15.4%*

Manufacturing

Until 2005, the Company engaged in limited manufacturing, relying heavily on contract manufacturers. In 2005, however, Father decided to bring all manufacturing in-house and planned to move to a new, custom-designed headquarters/manufacturing facility that was completed at year-end. Father owns the land and building and leases it to RuffCo, which owns all the manufacturing equipment, financed by an equipment loan from its traditional asset-based lender, the Bank. In 2006, RuffCo purchased the lot adjacent to Father's and constructed a state-of-the-art packing and distribution warehouse that was integrated with the manufacturing operation. Such expenditures were financed with additional loans provided by the Bank. The Company's balance sheet, reflecting its new debt facilities, is illustrated in table 2.

Table 2

RUFFCO SUMMARY HISTORICAL BALANCE SHEET *($ in Millions)*

	2005A	2006A	2007E
Assets:			
Account receivable	$6.2	$10.0	$14.2
Inventory	6.6	11.2	16.4
Total net fixed assets	21.2	48.8	49.2
Total assets	$34.0	$70.0	$79.8
Liabilities:			
Total current liabilities	4.2	6.4	9.0
Back debt			
Revolver	2.8	9.8	19.2
Term	-	10.0	8.8
Equipment 1	19.2	16.4	13.8
Equipment 2	-	16.0	13.8
Total bank debt	22.0	52.2	55.6
Total liabilities	26.2	58.6	64.6
Shareholders equipment	7.8	11.4	15.2
Total liabilities and s/holders equity	$34.0	$70.0	$79.8

The Dinner

In the summer of 2007, Thomas Slick III, an investment banker, took Son out for drinks and a steak dinner to pitch him the idea of an "important transaction" for RuffCo. Slick refused to divulge the specifics of his plan until he met with Father, but outlined for Son the financial ramifications of his proposal.

Slick began by providing a back-of-the-envelope valuation of RuffCo and of Son's stake in the Company. Assuming RuffCo would meet its budget of $20 million of earnings before interest, taxes, depreciation and amortization (EBITDA) for the full year of 2007, Slick applied a comparable company-based multiple of 7x (approximately 80% of the median of the comparable public company multiples), arriving at an Enterprise Value of $140 million (the market multiples valuation technique is described in more detail later). Slick subtracted the Company's expected year-end interest-bearing debt of $55.6 million to arrive at an equity valuation of $84.4 million. As the owner of 12.5% of RuffCo, Son's share of the Company in 2007 was worth approximately $10.6 million. Assuming a 15% annual EBITDA growth rate, Slick suggested that in two years Son's stake could be expected to grow to almost $14 million. "Not bad," said Son. "Not bad at all," replied Slick. However, he reminded Son that his minority stake in the privately held company was extremely illiquid. Slick explained that the best way to achieve liquidity was to establish a public market for the shares of the Company through an initial public offering (IPO) of RuffCo shares. In order to help maximize the value that investors place on an IPO, Slick counseled, RuffCo would need a plan to show both immediate and long-term growth possibilities. Since Son admitted that RuffCo's internal growth was waning, Slick suggested that the Company use the proceeds of an IPO to grow through acquisition.

At this point, Slick told Son that he could present RuffCo with an opportunity to purchase a compatible golf club manufacturer that, combined with RuffCo, would produce pro forma 2007 sales of $166 million and EBITDA of $27.2 million. Although Slick assured Son that the target company had a new product that would enable its operating cash flow (EBITDA) to grow more than 25% annually over the next few years, Slick said that even if (as a conservative estimate) the combined Company's EBITDA grew at RuffCo's projected 15% per year over the next two years, it would produce EBITDA of $36 million in 2009. (Slick focused on 2009 because in 2008 the target's significant marketing costs associated with its new product would depress the target company's true profitability.) Slick explained that, given its greater size and liquid publicly traded shares, the combined company could fetch a multiple of approximately 8x its EBITDA for an Enterprise Value of "at least" $288 million in 2009, a mere two years away. Then, Slick subtracted interest-bearing debt of $88.6 million (which he assumed to remain constant following the proposed acquisition and IPO) from the Enterprise Value to arrive at a 2009 equity value of $199.4 million. Although an IPO offering 30% of the Company to the public would decrease Son's stake to 8.75% of the Company, Son's now-liquid share of the Company at the end of 2009 would be worth over $17.4 million, which represents a 26% improvement over the RuffCo stand-alone scenario. "Now that's a good deal," said Slick.

"And that's not all," Slick continued. Taking the Company's combined 2007 pro forma numbers rather than projections for 2009, Slick estimated that he could take the Company public in a matter of months at an 8x EBITDA multiple for a pre-IPO Enterprise Value of $217.6 million. Subtracting the pre-IPO, post-acquisition debt of $125.4 million estimated after obtaining bridge financing to acquire the target, the Company would have equity value of $92.2 million and a post-IPO equity value of $131.7 million, assuming a sale of 30% of the equity. If Father sold approximately 10% of the Company in a secondary offering, he could gross (pretax) about $13.2 million and retire. "That," whispered Slick, "would leave you to run the Company." Son excused himself from the table. When he returned, he told Slick that Father would host Slick at his office at 10:00 a.m. the next morning.

The Investment Banker Presentation

At Father's office the next day, Slick outlined his vision to Father and provided the Ruffs with the name of the company he advised RuffCo to purchase: Peter Putter, Inc. Its sole product, the Peter Putter, a high-end putter with a milled face, attracted a loyal following of golfers willing to spend the money necessary for a high-quality putter. In addition, Peter Putter's East Coast presence and distributor network would complement RuffCo's West Coast dominance. Peter Putter was also making inroads into many of the "big box" retail stores. A combination would open that important sales outlet to RuffCo's products. Additionally, Slick was confident that the two companies would have significant synergies and cost savings on the order of $2 million each year. Best of all, RuffCo would be buying the company just before the money really started to roll in; the company was conducting final R&D on its latest-model putter, the Peter Putter II, which would be ready for market in early 2009. (This effort would require $12 million to fund additional marketing and

product development expenses.) Peter II, as the new putter was called, featured a hard insert that would produce crisper rolls on the greens and, Slick explained, was expected to be a blockbuster of "Bertha-esque" proportions.

Slick took the liberty of presenting the pro forma 2007 profit and loss statement for the combined entity (see table 3). The Ruffs were intrigued and hired Slick to get the deal done.

Table 3

RUFFCO GOLF PRO FORMA P&L CALCULATION *($ in Millions)*

	RUFFCO	PETER PUTTER	PRO FORMA 2007
Revenue	$130.0	$36.0	$166.0
Cost of goods sold	77.0	20.0	97.0
Gross Profit	53.0	16.0	69.0
Gross Margin	*40.8%*	*44.4%*	*41.6%*
SG&A	39.2	10.8	50.0
EBIT	13.8	5.2	19.0
Interest expense	5.0	2.0	7.0
Pretax income	8.8	3.2	12.0
Taxes	3.6	1.3	4.9
Net Income	$5.2	$1.9	$7.1
EBIT	$13.8	$5.2	$19.0
Manufacturing depreciation	6.2	2.0	8.2
EBITDA	$20.0	$7.2	$27.2
% Margin	*15.4%*	*20.0%*	*16.4%*

Acquisition, IPO and Refinancing

Impressed by the profit-making possibilities for the Peter II and hopeful that the distribution synergies would benefit RuffCo's existing product, RuffCo purchased Peter Putter at a multiple of approximately 9x its 2007 EBITDA of $7.2 million. The Ruffs accomplished the purchase by obtaining "bridge" financing from the Bank, which was to be immediately repaid from equity raised in an IPO. To clarify to the market its broader focus and new product line, the Company would change its name to "RuffCo Golf."

Table 4

PURCHASE PRICE OF PETER PUTTER
($ in Millions)

LTM EBITDA	$7.2
Acquisition Multiple	9.0x
Purchase Price	64.8
Debt Assumed	24.4
Equity Purchase Price	40.4
Fees and Expenses	5.0
Total Uses of Funds	$45.4

Acquisition

The Company acquired the equity of Peter Putter for $40.4 million plus $5 million of fees and expenses by borrowing $45.4 million from the Bank. At the time of the acquisition, Peter Putter had $24.4 million of debt, which included (i) a revolver with a balance of $11.6 million (overdrawn, with the Bank's permission to fund Peter Putter R&D) and (ii) $12.8 million of term and equipment debt.

IPO

At the time of the IPO, the "pre-money" Enterprise Value of the combined Company was $217.6 million, a multiple of 8x its pro forma 2007 EBITDA of $27.2 million. The Company then sold 30% of its fully diluted shares to the public (OTC: RUFF) in an IPO for a total of $39.5 million, resulting in a "post-money" equity value of $131.7 million. In addition to paying professional fees and expenses, the Company used the proceeds of the IPO to pay down $14.4 million of its revolver and $22.4 million of its term debt, leaving the Company with bank debt of $88.6 million at the close of the transactions and $10 million of remaining availability under its revolver.

Table 5

IPO PROCEEDS *($ in Millions)*

Pro Forma EBITDA	$27.2
Capitalization Multiple	8.0x
Pre-Money Enterprise Value	$217.6
Existing Post-Acquisition Debt	125.4
Pre-Money Equity Value	$92.2
% of primary shares sold	30%
Post-Money Equity Value	$131.7
IPO Proceeds	$39.5 [1]

[1] Before fees and expenses

The following sets forth RuffCo Golf's pro forma Balance Sheet for the acquisition of Peter Putter and the IPO.

Table 6

RUFFCO GOLF PRO FORMA 2007 BALANCE SHEET

(With Acquisition and IPO Adjustments) ($ in Millions)

	RUFFCO 12/31/2007	P. PUTTER 12/31/2007	Purchase Adjust. Debit	Purchase Adjust. Credit	IPO Adjust. Debit	IPO Adjust. Credit	Pro Forma 12/31/2007
Assets:							
Accounts Receivable	$14.2	$4.0					$18.2
Inventory	16.4	4.8					21.2
Net fixed assets	49.2	15.2					64.4
Intangible assets	-	10.0	37.6		2.7		50.3
Total assets	$79.8	$34.0					$154.1
Liabilities:							
Total current liabilities	9.0	1.8					$10.8
Bank debt							
Revolver	19.2	11.6			14.4		16.4
Term	8.8	4.6		45.4	22.4		36.4
Equipment Loans	27.6	8.2					35.8
Total bank debt	55.6	24.4					88.6
Total liabilities	64.6	26.2					99.4
Shareholders equity	15.2	7.8	7.8			39.5	54.7
Total liabilities s/holders equity	$79.8	$34.0					$154.1

In conjunction with the IPO, Father sold secondary shares representing 10% of the pro forma equity of the Company and kept the proceeds. Table 7 illustrates RuffCo Golf's ownership pre- and post-IPO (including Father's secondary sale of stock).

Table 7

RUFFCO GOLF OWNERSHIP

	Pre-IPO	Post-IPO
Father	75.00%	42.50%
Son	12.50%	8.75%
Daughter	12.50%	8.75%
Public	0.00%	40.00%
Total	100.00%	100.00%

THE SPIRAL OF DISTRESS

Shortly after the IPO, RuffCo Golf's fortunes, along with those of much of the golf industry, began to slide. The series of missteps and misfortunes that befell RuffCo Golf are summarized below.

In January 2008, RuffCo Golf completed its acquisition and IPO. Largely because of the stress of the acquisition and the IPO road show process, Father quietly announced his intention to relinquish daily operating responsibility and serve only as chairman. (True to Slick's prediction, the $13.2 million in pretax proceeds from his secondary offering eased Father's decision.) Son, now five years out of business school and executive vice president of sales and marketing, was given the title of president and chief executive officer. The Company began the search for a new head of sales and marketing.

The imminent innovations to the Peter Putter line represented an important part of the rationale for paying a relatively high multiple for the acquisition of Peter Putter (9.0x EBITDA). Peter Putter had designed and tested the ceramic insert for its new line of putters, the Peter II, at its test greens in Sarasota, Fla. The super-hard insert was reported to produce a crisp roll that improved players' putting on average greens. (The Company was also experimenting with both (i) a super-soft line of putters, the SofPut, to be released within a year of the Peter II, and (ii) RuffCo Golf's first swing at the lucrative driver market with its driver, the "House.")

Excited over the product and seeking to prove his mettle to analysts and competitors as the new CEO, Son (without the input of the R&D scientists working on the line) started leaking news of the Peter II, which would still not be ready for the market for another six months. Unfortunately, Son's actions (i) caused the Company's head scientist working on the Peter II to "stress out" and passionately reiterate his inability to commit to Son's time frame, (ii) alerted the Company's competitors to the new product, enabling them to downplay the Company's advances while coming up with their own plans for competitive putters, and (iii) cannibalized the Company's original Peter Putter, as customers decided to wait for the innovation rather than spend money on the old line.

After incurring additional R&D expenditures (diverting precious funds from the development of the House and the SofPut), the Peter II was completed. RuffCo Golf formally announced the breakthrough at an event during the U.S. Open in Minneapolis, which was experiencing some unseasonably cold weather. It was at this unveiling that Son decided to take a few putts to demonstrate the Peter II's handling. Then catastrophe struck: With the first bold stroke, the putter's face splintered, exposing the inner core. While the tests had gone well enough down in Florida, the scientists, rushing to complete their work, never completed any tests in temperatures colder than 55 degrees. Later tests showed that temperatures below 45 degrees shrank the super-hard insert, leaving the putter vulnerable to splintering on impact.

Although the Company fixed the problem that caused the splintering, the line (known in some circles as the "Edsel" of putters) never completely recovered from the public relations gaffe.

Image was not the only problem. Peter Putter's primary customer, high-end golfers, complained about the new putter's lack of feel ("like putting with a sledgehammer"). In the face of lackluster sales, Son overcompensated by increasing the advertising budget. The Company's inventory swelled with unsold and returned Peter IIs. Despite an attempt to stimulate demand by lowering prices, the Peter II generated very modest sales for the Company.

The Company's problems with the Peter II reverberated throughout RuffCo Golf. Senior management was distracted by its almost exclusive focus on the Peter II. By fixing the Peter II and then trying to advertise its way out of its difficulties with the putter, the Company diverted money and attention away from its core Ruffhouser fairway woods business as well as the development of its new House drivers and the SofPut. At the end of 2009, the Company finally discontinued the Peter II and wrote off $12 million for R&D and $2 million for product returns, each attributable to the Peter II.

In addition, the Company was forced to take additional extraordinary write-downs in accounts receivable of $2 million in 2008, $1 million in 2009, and $2 million in 2010 from troubled customers (retail chains and distributors) severely impacted by the industry turndown and global financial collapse, described in more detail below.

Golf Industry

Compounding all of the problems within RuffCo Golf was the credit crisis of the fall of 2008, which in turn spawned the "Great Recession" of 2009 and 2010. Unemployment ballooned, real estate values collapsed and consumer spending shrank. All of which had devastating effects on the entire golf equipment business. The channels drastically reduced inventories in the face of decreased demand in order to preserve precious liquidity in the absence of reliable sources of credit. In the golf equipment industry overall revenues fell by more than 10%. Revenues from high-margin drivers and metal woods fell by nearly 30%.

Even prior to the financial crisis, the late 2000s had been tough on all participants in the golf industry, both large and small, including those who, like RuffCo Golf, had gone public when times were good. Some, like Coastcast, had been sold to Asian competitors with whom they could no longer compete. Others, like Royal Precision, had been sold to domestic competitors who ultimately filed bankruptcy and ended up in the hands of private equity players. And some, like Teardrop, simply closed down in the face of foreign competition and a brutal recession. As tough as things were at RuffCo Golf, it was not alone in its suffering.

In sum, RuffCo Golf was facing critical issues both inside and outside the Company. RuffCo Golf's deteriorating financial results for 2008 through 2010 resulting from all these issues are summarized in table 8.

Table 8

RUFFCO GOLF HISTORICAL CONSOLIDATED INCOME STATEMENT

($ in Millions)

	2008	2009	2010
Revenue	$182.2	$179.1	$164.4
Growth	*9.8%*	*-1.7%*	*-8.2%*
Cost of Goods sold	109.0	112.8	107.8
Gross Margin	73.2	66.3	56.6
SG&A	63.0	68.6	62.4
EBIT	10.2	(2.3)	(5.8)
Interest expense	8.2	8.6	8.0
Write-downs	2.0	15.0	2.0
Taxes	1.0	(9.4)	(5.4)
Net Income	($1.0)	($16.5)	($10.4)
EBITDA	$22.8	$10.9	$7.6
% Margin	*12.5%*	*6.1%*	*4.6%*
Debt service (includes interest and principal)	$20.2	$20.6	$19.8
Capital expenditures	$5.6	$3.6	$4.6
EBITDA/Debt service	1.13	0.53	0.38
(EBITDA-Capital expenditures)/Interest	2.10	0.85	0.38

Operating and Financial Difficulties

Dropping from its high of approximately $20 per share to about $0.375 at the end of 2010, the Company's stock price closely reflected the troubles facing RuffCo Golf. The Company's liquidity was eroded by cost overruns, low demand for the Peter II, the expenses involved in redesigning and marketing the new clubs, general management distraction and the effects of a global recession the likes of which had not been seen in 80 years. By the end of 2010, the Company was over-advanced on its Bank revolver. Faced with such news and an impending "going concern" opinion from the Company's auditors, Moneybags resigned from his position on the Board.

Table 9

RUFFCO GOLF, INC. CONSOLIDATED BALANCE SHEET
THREE YEARS ENDED DECEMBER 31, 2010 *($ in Millions)*

	2008	2009	2010
Assets:			
Accounts Receivable	$24.8	$27.0	$16.4
Inventory	$28.6	$32.2	$25.6
Total current assets	$53.4	$59.2	$42.0
Net fixed assets	$61.0	$55.2	$49.8
Intangible assets	$49.0	$33.2	$29.4
Total assets	$163.4	$147.6	$121.2
Liabilities:			
Total current liabilities	$16.8	$24.8	$29.4
Bank Debt			
Revolver	$32.2	$36.8	$28.2
Term	$31.2	$26.0	$20.8
Equipment Loans	$29.2	$22.6	$15.8
Total bank debt	$92.6	$85.4	$64.8
Total liabilities	$109.4	$110.2	$94.2
Shareholders equity	$54.0	$37.4	$27.0
Total liabilities and s/holders equity	$163.4	$147.6	$121.2

By December 31, 2010, while the Bank had been paid down to $64.8 million, the Company's shareholders equity account had been eroded to $27 million, as illustrated in the Consolidated Balance Sheet on table 9.

All the Company's business constituencies were now very concerned. Vendors had bent over backwards to be supportive, while at the same time suffering from many of the same recessionary woes affecting RuffCo Golf. Accounts Payable had been stretched to the breaking point. By the end of 2010, payments on Accounts Payable averaged approximately 125 days! At this point, the vendors, well aware of the Company's operating and financial problems, refused to extend RuffCo Golf further credit, sending product only on a COD or CIA basis. Customers, such as retailers and golf shops, became concerned and requested that RuffCo Golf confirm that it would be in a position to honor its warranty commitments and ship product on a timely basis going forward. The competition seized on RuffCo Golf's weak position, offering RuffCo Golf's best retailers great deals in order to win their business. Moreover, RuffCo Golf's outside counsel had contacted the Company to alert it to the fact that a local law firm specializing in shareholder class-action suits called him following a *Forbes* article, "RuffCo Golf Stock 'Out of Bounds' for Frustrated Shareholders."

In early 2011, Son, like many entrepreneurs, continued to remain firm in his belief that RuffCo Golf's future was bright and that with a recovering economy and additional money to finish the designs, the launch of the House and SofPut lines would catapult the Company back to success. Thus, he was eager to meet with the Bank to discuss his request for additional financing. It just so happened, the Bank was eager to meet with Son as well, to discuss the over-advance on RuffCo Golf's revolving credit facility.

The Bank was also having problems of its own, as the real estate crash resulted in its balance sheet being burdened with a slew of bad commercial real estate loans, threatening its capital adequacy. The Bank stated that, effective immediately, a new team (the "Workout Group") would be handling the RuffCo Golf credit. The Bank called a meeting with Father and Son to (i) discuss the over-advance, (ii) obtain a current net worth statement from Father, who had personally guaranteed the bank debt (a holdover from the Company's days as a private company) and (iii) demand that the Company refinance its debt immediately. The Company had always enjoyed an excellent working relationship with the Bank, which had an account manager who was an avid golfer. So the Company was surprised by the tough tone of the new team of non-golfers.

Table 10

REVOLVER AVAILABILITY *($ in Millions)*

		FYE 2010
Accounts Receivable		16.4
% Ineligible		5.0%
Advance rate		85.0%
Net availability		$13.2
Raw materials	5.6	
% Ineligible	0.0%	
Advance rate	70.0%	
Net availability	$3.9	
Finished goods	17.0	
% Ineligible	5.0%	
Advance rate	60.0%	
Net availability	$9.7	
Inventory – Net availability		$13.6
Sublimit		20.0
Inventory availability		13.6
Total borrowing base		26.8
Indicated Revolver Balance		28.2
Indicated Availability		($1.4)

At the suggestion of its general counsel, RuffCo Golf retained outside counsel experienced in "situations of distress" to advise it in connection with reviewing its strategic alternatives.

THE BANK MEETING

At the meeting, the Ruffs met members of the Bank's Workout Group for the first time. Son made a presentation to the Bank, showing near-term cash shortfalls in the millions before the Company's House and SofPut lines were introduced in approximately six months. Thereafter, his projections illustrated the Company would immediately generate positive cash flow in a "Hockey Stick" fashion.

The Bank listened to Son's presentation and questioned many of his underlying assumptions. While the meeting was cordial, it was clear that the Bank was "concerned" about the credit and "skeptical" that the Company could effectuate a dramatic "turnaround" in a relatively short period of time, in a still uncertain economic climate.

Then, Son also mentioned (almost off-handedly) that, as a result of continued club returns and excess unsold inventory, the Company would be forced to take additional write-offs.

The Bank immediately explored the inventory write-off issue and, together with the Company, calculated that the Company was now $3 million over-advanced on its revolving credit facility (as compared to the $1.4 million over-advance before the additional write-offs). To make matters worse, near-term cash shortages were expected to occur due to further anticipated product returns, and marketing and legal expenses, which are items that would not create current assets to improve the Company's revolver availability – further exacerbating the over-advanced position and resulting in an even bigger over-advance. The Bank also focused on Father's financial position, which indicated a $19.8 million net worth.

Questioned by the Bank about the value of the Company's assets and business, the Company disclosed that a Chinese company had recently offered to purchase certain assets of the cash-bleeding Peter Putter business for $4 million in cash, plus assumption of the equipment loans ($3.6 million) and certain accounts payable and accrued expenses (collectively $5.2 million). Although on a stand-alone basis Peter Putter had negative cash flow in 2009 and looked like it might just break even in 2010, Son, recalling the $64.8 million price tag RuffCo paid at the end of 2007, as well as the millions in R&D expenditures since then, summarily rebuffed the offer as "grossly inadequate."

After further discussion, the Company and the Bank agreed to adjourn to decide upon their respective strategies.

COMPANY'S OPTIONS AND STRATEGY

The Company meets with its new bankruptcy counsel who explains that, given its current circumstances, the Company has four options.

Refinancing

The Company can attempt to refinance. Indeed, during recent years when cheap credit had been abundant, RuffCo Golf had received calls from several asset-based lenders and, prior to the credit crisis of 2008, had considered the feasibility of obtaining fresh senior secured capital to pay off the Bank, which even back then was beginning to experience problems from its commercial real-estate activities and was becoming increasingly inflexible and uncooperative. Counsel also advises Father that any additional equity investment from him would substantially ease the Company's burden.

- **Advantage:** Refinancing—especially with a major equity commitment from an outside investor, or Father—would help promote economic stability and could help revive the confidence of the customers and vendors. The Company would enjoy a fresh start with a new lender.
- **Discussion:** Unfortunately, in a turnaround situation of this magnitude, it is difficult to develop a coherent business strategy sufficient to attract new investors, who usually see more risks than upside, especially with the specter of shareholder litigation looming. Without any prior history with the Company, new lenders are unlikely to have a substantially different perspective on the financial viability of the Company than existing lenders. Moreover, because of the liquidity constraints of the Company, any new equity or debt financing would have to be raised quickly. In addition to all that, the halting economic recovery of early 2011 coupled with a continuing aversion by a recovering credit market to stressed middle-market credits make refinancing prospects bleak for a company like RuffCo Golf, particularly when many smaller regulated lenders, like the Bank, are still struggling with balance sheet issues of their own.

Selling the Company

The Company can pursue an immediate sale, which would "stop the bleeding" by minimizing the risk of continued value erosion or a "free fall" into bankruptcy proceedings.

- **Advantage:** An immediate sale could provide existing shareholders the best opportunity to realize the equity value, if any, remaining in the Company. Moreover, a sale could ease tensions with both secured (Bank) and unsecured (trade vendors, landlords) creditors, who would be encouraged that a near-term sale would provide the stability necessary to preserve going-concern value and ongoing business to the Company's suppliers.
- **Discussion:** At this point, the Company may only be able to command a depressed price because of the difficulty of convincing buyers of the

turnaround potential of a troubled company and the continuing uncertainty caused by the lingering recession, high unemployment and the lack of recovery in consumer discretionary spending. Moreover, competitors may become aware of and attempt to exploit a sale process for their own ends (talking to creditors, advertising to customers, etc., and creating additional concern about the Company's future). Finally, for the Ruffs, after paying off the creditors, a sale would likely eliminate any remaining option value inherent in their equity position. Thus, the Ruffs would forfeit the potential upside of future blockbuster performance from the House or the SofPut, and could also be left with little to show for their years of work at the Company.

Consensual Financial Restructuring

In lieu of either a refinancing or a sale, the Company can attempt to restructure its financial obligations. The restructuring would have to provide additional working capital to the Company (through an equity infusion, a reduction of senior debt and/or a significant reduction in near-term debt service) and it would have to fairly allocate the risks and benefits of the restructuring strategy.

- **Advantage:** If there is a high degree of trust among the constituencies and basic agreement on the turnaround plan, quickly resolving the Company's financial difficulties without relying on third parties can be the best alternative. If handled properly, this approach can help minimize the amount of time that the Company operates under financial duress.
- **Discussion:** A successful financial restructuring requires the active cooperation of a number of constituencies, each acting in its own best interest, but each understanding that it benefits by reasonably accommodating others. Most often, senior secured lenders are reluctant to increase their exposure by financing a restructuring, especially when an immediate sale or refinancing may provide a quick exit from the credit. For their part, owners of businesses are often unrealistic as to what is achievable in these circumstances. Such owners may entertain the unreasonable expectation that senior secured lenders will take "equity" risk for a "debt" return just so the owners can preserve their interests. Discussions often break down at the first step as there is no agreement as to the risks and benefits of a turnaround plan.

From the Company's perspective, the Bank is becoming hostile and the Company's trade creditors unsupportive. In these circumstances, it is common to evaluate consensual restructuring alternatives by comparing them to what would or could occur on a non-consensual basis within a Chapter 11 bankruptcy proceeding (this is known as negotiating in the "shadow" of the Bankruptcy Code). To prompt greater cooperation from the Bank, the Company is likely to "explore" (in reality, threaten the Bank with) one or more of the following actions:

Priming Lien: The Company can threaten to raise new money senior to the Bank. Under Section 364(d)(1) of the Bankruptcy Code, if the Debtor can prove that it is unable to otherwise obtain credit and that there is "adequate protection" of the claim of the current lienholder, the Court can approve the granting of a senior or equal lien (a "priming lien") on property subject to a lien. "Adequate protection" is a concept addressed in Section 361 of the Bankruptcy Code. While Section 361 does not define adequate protection, it specifies three non-exclusive methods of providing adequate protection: (i) periodic cash payments, (ii) an additional lien on property and (iii) other relief which results in the secured party's realizing the "indubitable equivalent" of the value of its interest in the collateral.

Use of Cash Collateral: A similar strategy involves the use of cash collateral whereby a Court, sometimes over the objections of the secured creditor, authorizes the Debtor to use the proceeds arising from the sale of its pre-petition inventory, collection of accounts receivable or other working capital, each of which may constitute the secured creditor's collateral, in the ordinary course of business. As discussed above, the Court must determine that the secured creditor is "adequately protected."

Cram-Down: The Company can threaten to confirm a plan of reorganization over the objection of the Bank. Under Section 1129(b)(1) of the Bankruptcy Code, a Court will confirm a plan of reorganization notwithstanding the fact that a class of claims or interests (e.g., the Bank) has not approved the plan, if such a plan is "fair and equitable," a determination explicitly set forth in Section 1129(b)(2). Specifically, 1129(b)(2)(A) provides that a plan can be fair and equitable with respect to secured claims if the plan provides (i) that the secured creditors retain their liens and receive deferred cash payments totaling at least the allowed amount of their secured claims and that such deferred cash payments include interest such that the deferred payments will have a present value equal to the amount of their secured claims; (ii) that the secured creditors' liens attach to the proceeds of any out-of-the-ordinary course sale of their collateral; or (iii) the realization by the secured creditors of the "indubitable equivalent" of their secured claims. One risk to the Bank is that a Court would approve a payment plan the Bank believes would defer its cash payments over an unreasonably lengthy time frame and/or at an insufficient rate of interest.

Lender Liability and Equitable Subordination: The Company can threaten the Bank with litigation that might result in liability, or lower priority compared to other creditors. Under a lender liability claim, the Debtor could assert that the Bank, as lender, acted in bad faith and was responsible, in whole or in part, for the Debtor's problems. Under an equitable subordination strategy, the Debtor (or perhaps the unsecured creditors) would attempt to convince the Court that, perhaps because of the Bank's actions, its loans should be subordinated to other debt of the Company.

Under-Collateralization: Another risk to the Bank is that the Company can assert that the Bank is undersecured and should be treated, at least in part, as a mere unsecured creditor. The Bankruptcy Code provides that if the assets securing the debt of a creditor's claim are insufficient to cover such claim, the claim may be bifurcated into secured and unsecured tranches, thereby lowering a portion of such creditor's priority. Moreover, only a fully secured creditor, not an undersecured creditor (even by a dollar), is entitled to post-petition interest, or even many fees and costs provided for in the credit agreement, which is a material issue in a lengthy bankruptcy. In the case of RuffCo Golf, the Bank may be subject to this attack because (i) the Company may properly assert that the realizable value of the Bank's collateral (principally the working capital and manufacturing assets) is less than the outstanding Bank debt and (ii) the Bank does not have a lien on certain intangibles, like patents, trademarks and copyrights.

Business/Collateral Deterioration: Under Chapter 11, the Company could use the automatic stay, which puts a halt to all litigation against the Company, to simply continue its business, using the Bank's collateral (i.e., inventory and accounts receivable). If the Company does not raise the capital it needs to re-energize the business, the value of both the business and the collateral securing the Bank's claim may diminish with time as a result of the taint of an ongoing bankruptcy with an uncertain outcome, coupled with the inability of the Company to operate effectively under its severe liquidity constraints and the threat that it may even run out of cash.

Moreover, bankruptcy creates time delays and high administrative costs for the Debtor, including fees for lawyers, experts and other professionals, and possibly for creditors too. In the RuffCo Golf situation, the above threats are a substantial stretch on these facts and may prompt a hostile response from the Bank and other creditors. Moreover, such tactics could scare off other potential sources of capital who witness RuffCo Golf's hard line approach.

File Chapter 11

The Company can file for Chapter 11.

- **Advantage**: A carefully planned Chapter 11 filing can be a superior means of preserving value by providing the Company with an opportunity to restructure all its obligations and pursue its turnaround with protection from creditors. A Chapter 11 filing would likely force concessions from both secured and unsecured creditors through various bankruptcy techniques, such as those outlined above. Moreover, a financially distressed and illiquid company may find that its best source of additional financing (i.e., debtor-in-possession financing) can only be obtained in Chapter 11.
- **Discussion**: A bankruptcy filing may cause significant business disruptions with customers, employees and vendors, and will also result in high administrative costs and professional fees. Most important, because of the doctrine of absolute priority in the Bankruptcy Code, whereby creditors must be paid prior to equity holders, bankruptcy filings result, more often than not, in equity holders being essentially wiped out.

Fiduciary Duties

In a Chapter 11, given the current value of the Company, the Ruffs likely will receive very little, or nothing, on account of their shareholdings. As majority equity holders, however, the Ruffs effectively hold a "call option" tied to the Company's performance. Their downside is limited (ignoring, for purposes of this discussion, Father's guarantee). However, as long as the Ruffs maintain their equity position, they continue to enjoy the potential of an upside "call option" should the Company be successfully turned around, accrete in value and potentially become worth substantially more than the debt. This "call option" creates a conflict between the shareholder/management incentive to "shoot for the pin" and the potentially more economically appropriate goal of "playing to the middle of the green," minimizing business volatility, stabilizing the Company and preserving the most value by "laying up".

To deal with this inherent conflict, case law has generally established that if a company is in the "zone of insolvency," the Board's duty to enhance shareholder value migrates to a general obligation to help maximize value for all interest-holders, both creditors and equity holders. For clearly insolvent companies, however, fiduciary duty is owed to the creditors.

Company Negotiation Strategy

After being instructed on their fiduciary duties and weighing the opinions outlined by their counsel, Father, Son and the rest of the Board decide to explore the Company's refinancing options and request the Bank to continue financing in the interim. During the refinancing process, Father will evaluate his personal situation and determine whether to invest additional capital in the Company. Such a strategy could be risky for the Company itself as it continues to deteriorate while the Ruffs look for additional capital to maintain the value of their "call option".

BANK'S OPTIONS AND STRATEGY

The Bank explores four options in seeking to protect its principal and interest.

Finance Turnaround

In consideration of an equity infusion and/or a grant of additional security interests in RuffCo's intangible assets as well as Father's non-RuffCo Golf assets, the Bank could extend new credit to the Company to finance a turnaround.

- **Advantage:** Additional capital from new credit and an equity infusion would enable the parties to avoid (at least temporarily) the costs and risks associated with a Chapter 11 filing. Moreover, an equity infusion would provide a cushion of capital subordinate to the Bank's interest and would provide the Company with the working capital it requires to prove the viability of the Company on a longer-term basis, and, depending on the size of the infusion, may allow the Bank to exit its investment in RuffCo Golf at some point, if it so desires.
- **Discussion:** Such additional capital, however, could be too-little-too-late, as it could be consumed by near-term cash-flow deficits, rather than addressing longer-term solutions. Therefore, this "solution", rather than being a lifeline to the Company, could instead result in a worse outcome for the Bank and other stakeholders than if the Company were sold prior to injecting additional capital.
- **Note on public companies:** For a public company, new equity financing would likely require a fairness opinion, particularly if the new investment came from an insider. A fairness opinion is a statement provided by an independent financial advisor that the proposed consideration, and terms thereof, for new equity in a merger, acquisition, divestiture, securities issuance or other transaction is fair, from a financial point of view, to a company and its existing shareholders.

To minimize fairness issues, a company could pursue a rights offering, which permits all shareholders to participate pro rata in an equity investment. Unfortunately, a rights offering can be time-consuming and expensive, and the results are uncertain. Thus, in order to guarantee that the required capital will be raised, a company could enter into an agreement with a party (often a well-capitalized insider, such as Father) to "backstop" or underwrite the offering. A backstopped rights offering maintains fairness for all existing shareholders and assures that the needed capital is raised, but, in turn, requires extra consideration for the "backstop" investor.

Conditional Financing

Recognizing that a "turnaround," while possible, is unlikely in light of RuffCo Golf's serious operational challenges and an uncertain overall economic environment, the Bank could take a much more active approach to managing its stake in the Company. While still pushing for new equity and/or additional collateral, the Bank could agree to provide some additional financing for a specified period so long as RuffCo Golf agrees to (i) take steps to stop the deficit cash flow; (ii) monetize certain of the Bank's collateral, some or all of the proceeds of which would pay down the Company's outstanding indebtedness to the Bank (i.e., sell Peter Putter and/or other assets); and (iii) actively seek alternative financing.

- **Advantage:** This strategy could provide a consensual basis for the Company to pursue its core business plan (on a limited basis) while allowing the Bank to keep a tight leash around the costs and expenses incurred by the Company. This arrangement also could create one or more sources of cash for a prompt principal pay-down for the Bank.
- **Discussion:** This course of action, although ostensibly more conservative, could simply tie the hands of management and actually be counter productive by limiting its ability to make a comeback. In other words, even this more conservative strategy on the Bank's part could result in a reduction in value that more drastic measures might otherwise preserve.

Demand Immediate Sale

In exchange for advancing the minimal amount of funds necessary to cover critical expenses, the Bank could require the Company to hire an investment banker to begin a full-scale sales effort to be conducted and consummated within an agreed-upon and short time frame.

- **Advantage:** This could be the most time-efficient strategy for the Bank as it would provide a fast payout (sales of this nature can proceed to consummation in as little as 90 days), thereby avoiding a long, contentious Chapter 11. This strategy would also allow the Bank to monetize its collateral while minimizing further erosion of value.
- **Discussion:** Unfortunately for the Bank, the Company will argue that a sale at this low point—before the House and/or the SofPut products enable the Company to make a financial comeback—is the worst possible strategy and one the Board cannot support. Moreover, such a proposal from the Bank again highlights the conflicting economic agendas of the creditors (both secured and unsecured)and the equity holders. While the creditors (both secured and unsecured) would be happy with a sales price at or above their respective exposure, shareholders would want to retain their stakes to maintain the economic value of their "call option".

Foreclosure

Foreclosing on the collateral securing its loans to the Company would eliminate the Bank's risk of throwing good money after bad. Of course, if it believed that the Company was acting in bad faith, this move would enable the Bank to strike quickly. Any attempted foreclosure, however, would inevitably provoke a Chapter 11 filing by the Company before the foreclosure process could be completed.

- **Advantage:** A Chapter 11 filing by the Company to legally stay a foreclosure can, however, have several benefits for the Bank, including, among other things, a heightened ability to monitor RuffCo Golf's (i) operations, (ii) out-of-the-ordinary transactions, (iii) insider transactions, and (iv) strategic decisions. Depending on the circumstances, a Court could rule for the Bank on such issues as limitation/prohibition of the use of the Bank's cash collateral, relief from automatic stay in order to allow the Bank to complete the foreclosure process, termination of the Company's exclusivity for proposing a plan of reorganization or, very unlikely under these facts, the appointment of a trustee. Moreover, under any scenario after a foreclosure proceeding is threatened or actually begun, the Bank

has significant negotiating leverage because of Father's personal guarantee of the Company's debts (action on which generally would not be "stayed" by the Company's Chapter 11 case).

- **Discussion**: In addition to closing off a number of potentially more profitable scenarios (i.e., sale or refinancing), a move to foreclose on its collateral could subject the Bank to the risks listed in the "Company's Options and Strategy" section above, including priming risks, cram-down risks, use of cash collateral, business/collateral deterioration, risk of being under-secured, and administrative costs and delays.

Bank Negotiation Strategy

After careful consideration, the Bank decides to advance new funds to the Company on a limited basis in order to finance operations. This action will be predicated upon (i) the Company adhering to a Bank-approved budget for the Company; (ii) the maximum additional collateral or infusion that can be coaxed from Father; and (iii) the Company's agreement to pursue a prompt sale or refinancing. The Bank's ultimate objective is to encourage an expedited sale process, thereby minimizing the period of the Bank's additional exposure to the greatest extent possible.

THE NEGOTIATED ACTION PLAN

The Bank and the Company negotiate professionally, but assertively, and ultimately agree to the following plan.

Additional Funding: Funding to a tighter budget than Son's original "Hockey Stick" forecast, the Bank will make additional funds available to the Company, up to a maximum of $2 million, using a lockbox arrangement, whereby all receipts are controlled by the Bank.

Sale of Subsidiary: Although Father supports Son's assessments regarding the inadequacy of the previously-received offer to buy Peter Putter, the Bank insists that the Company promptly sell the Peter Putter business. While the Ruffs continue to believe in the SofPut, they have more confidence and pride in their original company, and they agree to sell Peter Putter. If the Company is able to close the offer for the Peter Putter business, the parties agree that the Company will use the cash to pay down its revolver, and that the Bank will agree to the buyer's assumption of certain equipment debt.

Crisis Management Team: Although Son resists, the Ruffs agree that if the situation worsens (i.e., the Company fails to adhere to the Bank-approved budget) they will hire a crisis manager (several of whom are recommended by the Bank) to assist the management team in its turnaround efforts, and the Ruffs agree to begin interviewing immediately. Crisis managers can provide financial and operating expertise in managing distressed company situations and maximizing cash flow.

Alternative Financing/Potential Sale: During the negotiations, Father has decided that he will not invest any more capital. The Ruffs agree that they will seek to arrange sufficient new financing to repay the Bank within 45 days, and that if they are unable to do so, RuffCo Golf will pursue a sale transaction for all of the remaining parts of the Company, but only, according to Father, "if the shareholders can retain some value".

Sale of Subsidiary

The Bank and the Company hold several more discussions regarding the sale of Peter Putter. Initially, such discussions center on whether or not to hire an investment banker to advise on the sale of Peter Putter and negotiate optimal terms. While the Ruffs continue to maintain that a higher price could be found, they are reminded that Peter Putter has bled substantial cash since 2008 and that the Peter Putter's prospects are badly damaged. The Ruffs, ultimately, agree with the Bank that speed and the risk of losing the buyer outweigh the desire to pursue alternative buyers through a more inclusive process. Without consulting an investment banker, the Company sells Peter Putter through a straightforward asset purchase structure.

As promised, the Company uses the proceeds to pay down debt owed to the Bank and certain trade creditors. The sale of Peter Putter necessitates certain adjustments to the Company's balance sheet. Along with the write-offs discussed earlier, the balance sheet on table 11 illustrates the Company's financial position after the sale of Peter Putter.

Table 11

RUFFCO GOLF BALANCE SHEET AFTER PETER PUTTER SALE, ADJUSTMENTS & WRITE-OFFS *($ in Millions)*

		Sale Adjustments		Pro Forma
	12/31/2010	Debit	Credit	12/31/2010
Assets:				
Total assets	$115.2*		$52.5	$62.7
Liabilities:				
Total current liabilities	29.4	5.2		24.2
Bank debt				
Revolver	25.8	4.0		21.8
Term	20.8			20.8
Equipment Loans	15.8	3.6		12.2
Total bank debt	62.4			54.8
Total liabilities	91.8			79.0
Shareholders equity	23.4		(39.7)	(16.3)
Total liabilities and s/holders equity	$115.2			$62.7

* *Post write-off*

Even after the sale of Peter Putter, it remains clear that without an influx of additional capital, the Company still suffers from substantial liquidity problems, and the Bank, although it has offered to provide Debtor-In-Possession Financing ("DIP Financing"), is still unwilling to finance the Company's turnaround. Thus, as agreed, the Company seeks a new lender to take out the Bank.

Refinancing Efforts

The Company contacts 10 asset-based lenders. Such lenders, many of whom had in better times called the CFO repeatedly expressing their strong interest in financing the Company, now decline to make proposals in light of the Company's continuing difficulties. Of the 10 lenders, eight decline interest and the other two offer DIP Financing proposals for a Chapter 11 in lieu of refinancing proposals. The Company's counsel explains to the Ruffs that DIP Financing involves borrowing money (generally on a senior secured basis) in Chapter 11 with Court approval. DIP loans are considered to be relatively safe by such lenders. As the Company still hopes to find a non-Chapter 11 solution, it decides at this point to pursue other means of refinancing.

The Company speaks informally with an investment banker regarding RuffCo Golf's ability to access either mezzanine or high-yield subordinated debt or equity capital to finance its turnaround. The investment banker informs the Company that, while companies with weaker credit ratings often issue high-yield debt, and even though high-yield issuance hit record levels in 2010, such debt is generally unavailable to smaller companies like RuffCo, particularly in turnaround situations.

After testing the waters with several prominent mezzanine investors, the investment banker advises the Company that the mezzanine market is also unreceptive, given RuffCo Golf's current level of distress and the attendant bankruptcy risk. Although they may believe in the House, these investors are unwilling to take on the risk without a proven turnaround strategy.

The investment banker also revisits the potential for raising new equity. However, a quick back-of-the-envelope valuation of the firm reveals that an equity infusion of adequate size would require ownership of substantially all the Company's equity, constituting in effect a sale of the Company. The investment banker indicates that a rights offering could provide the necessary capital, but only if Father would backstop the offering. Unfortunately for the Company, Father has already indicated that he is unwilling to do so.

In light of such factors, the investment banker instead advises the Company to pursue an immediate sale transaction, which he believes will preserve greater potential value (if any) for existing equity by saving both time and money. Reluctantly, but with the hope that some existing equity value remains, the Board, including Father and Son, agrees to begin the sale process.

Retention of Investment Banker

Although it had been informally advised, the Company has yet to hire an investment banking firm. The Company's bankruptcy counsel suggests that the sooner an investment banker is retained, the better. Indeed, once the decision to sell a distressed company is made, an expedited sale process minimizes the risks of an operational meltdown (leading to liquidation) or a reduced sale price due to continued value erosion. Moreover, the investment banker will need to quickly assess the operations of the business and work with the Company to develop a detailed presentation of non-public financial information for distribution to potential investors. Where appropriate, the presentation may include (i) pro forma restatements of historical earnings and cash flow (to reflect, for example, the sale of Peter Putter and other write-offs and adjustments) and (ii) viable financial projections reflecting a credible turnaround or value realization "story". Key factors in evaluating an investment banker to broker a distressed company include:

- Expertise in understanding distressed company situations, evidenced by an understanding of the financial, operational and legal issues involved in articulating distressed company value and effectuating transactions, both in- and out-of-court.
- Long-standing relationships with potential strategic and/or financial buyers, crisis managers, law firms and others integral to a successful resolution of a distressed company sale transaction.
- Senior-level bankers committed to a deal with proven execution capabilities and with whom management feels comfortable and confident.

The Company must consider the investment banker's fees in terms of magnitude and incentive structure. Fee structures vary widely, but generally provide for both non-refundable retainers (and/or monthly fees) and a success fee based upon a percentage of the total selling price, often subject to a stated minimum and increased percentages, based on increased value. The smaller, more difficult transactions generate a higher transaction fee percentage.

Bankruptcy counsel advises the Company that, when hiring an investment banker in these circumstances, the Engagement Letter will likely provide for (i) the possibility of a bankruptcy filing and the procedures to be taken by the Company with respect to the investment banker's employment in such event, and (ii) some mechanism to assure payment of the investment banker's fee in the event that creditors are not paid in full.

In the RuffCo Golf situation, the Company naturally decides to hire Houlihan Lokey ("Houlihan Lokey") (it is, after all, our case study), an investment banking firm with unsurpassed financial restructuring and distressed company M&A expertise.

Adjusting and Projecting Financial Information

For RuffCo Golf, Houlihan Lokey's first job is to work closely with management to understand the Company's past performance and future prospects, as well as to develop appropriate financial information for the sale process. Often, a company's historical financial statements, particularly those of a company in distress, fail to portray the true cash-flow generating capabilities of the enterprise. In such cases, an investment banker will generally look for opportunities to "recast" or "normalize" financial statements in order to paint a more "accurate" portrait of the company's profitability. This is frequently true in private companies, where the line between business and personal expenses is often blurred.

Recast Financials

Typical adjustments used to recast an Income Statement include:

<u>Cost of Goods Sold Adjustment:</u> When a company encounters financial difficulties, its Cost of Goods Sold may increase for several reasons, including (i) lack of discounts from vendors because volume purchasing has decreased and credit risk has increased; (ii) higher costs associated with rushed projects because of poor planning or liquidity problems; and (iii) increased reliance on local, over more cost-efficient international vendors that recognize lines of credit.

<u>Nonrecurring Professional Fees</u>: In a turnaround scenario, a company hires financial advisors, lawyers, turnaround managers and other advisors. These expenses should be subtracted from a company's income statement to reflect a lower cost of doing business during normal times. Moreover, a company may have nonrecurring lawsuits unrelated to the restructuring process, for which it has incurred substantial professional fees.

<u>Nonrecurring Costs</u>: A company may have incurred nonrecurring costs, which should be added back to the income statement to obtain a more realistic indication of earnings. RuffCo Golf, for example, incurred substantial marketing costs because Peter II's failures were spread across the entire Company's product lines. Houlihan Lokey has added these extraordinary costs back to RuffCo Golf's income statement.

<u>Adjustment for Above-Market Lease Expense</u>: A company burdened by an above-market lease may have the opportunity to renegotiate onerous terms in the distressed sale context. In such cases, the income statement may be recast to illustrate the impact of such lease costs. Conversely, one may wish to add marginal cost to reflect any soon-to-expire below-market leases to reflect the true costs of doing business in that area.

<u>Excess Salaries Over Market</u>: In order to avoid double taxation and pull money out of the business, owners of a privately held company may pay high salaries to family members. When preparing normalized financial statements, one might adjust these salaries down to market levels indicative of the actual costs of management going forward.

Note: In the sale of a public company, the financial statements will often have to be de-consolidated to provide insightful information on individual businesses (often divisions or subsidiaries) and product lines. On the other hand, being subject to public scrutiny and owing a fiduciary duty to public shareholders, publicly traded companies may not require some of the adjustments common in private companies (e.g., excess salaries, "non-business" expenses, etc.). Public companies also have significant costs associated with SEC reporting and Sarbanes-Oxley compliance. Such costs may either disappear if the business is acquired by a private company, or be substantially reduced, on an allocated basis, if the acquirer is public and already incurs many of the fixed costs associated with such reporting and compliance.

Based on the input of Houlihan Lokey and in order to illustrate more normalized performance, RuffCo Golf adjusts certain extraordinary or nonrecurring costs that have depressed earnings for the past few years and recasts RuffCo Golf's income statement, pro forma for the Peter Putter sale (see table 12).

Table 12

RECAST HISTORICAL INCOME STATEMENT PRO FORMA FOR PETER PUTTER SALES AND ADJUSTMENTS *($ in Millions)*

	2007	2008	2009	2010
Revenue	$130.0	$139.8	$144.0	$136.8
EBIT	13.8	10.2	5.2	(1.2)
EBITDA	$19.8	$17.0	$12.4	$6.2
% Margin	*15.2%*	*12.2%*	*8.6%*	*4.5%*
Adjustments				
Cost of Goods Sold	0.0	0.0	2.0	2.0
Nonrecurring Professional Fees	0.0	1.0	1.0	2.0
Extraordinary Marketing/PR Costs	0.0	0.0	2.0	2.0
Lease cost adjustments*	1.0	1.0	1.0	1.0
Excess Salaries*	1.0	1.0	1.0	1.0
Adjusted EBIT	15.8	13.2	12.2	6.8
Adjusted EBITDA	21.8	20.0	19.4	14.2
% Margin	*16.8%*	*14.3%*	*13.5%*	*10.4%*

** The high lease cost charged by Father and the high salaries paid to Father, Son and Daughter are holdovers from the Company's days as a privately held entity.*

Projections

Houlihan Lokey also facilitates the development of the Company's business plan, persuading management to tone down the excessive "Hockey Stick" nature of Son's business plan, illustrating a more plausible turnaround story; less of a revolution and more of an evolution. Table 13 illustrates the Company's resulting projected income statement for the next three years.

Table 13

PROJECTED INCOME STATEMENT *($ in Millions)*

	2010A	2011E	2012E	2013E
Revenue	$136.8	$150.5	$158.0	$162.7
Growth	*-5.0%*	*10.0%*	*5.0%*	*3.0%*
Cost of Goods Sold	88.9	96.3	99.5	100.0
Gross Profit	47.9	54.2	58.5	62.7
Gross Margin	*35.0%*	*36.0%*	*37.0%*	*38.5%*
SG&A	49.1	46.4	46.8	48.2
EBIT		7.8	11.7	14.5
Manufacturing depreciation	7.4	7.8	8.3	7.3
EBITDA*	6.2	15.6	20.0	21.8
% Margin	*4.5%*	*10.4%*	*12.7%*	*13.4%*

* *Recall 2010 recast of $14.2 million*

As indicated, the Company expects to turn around its fortunes over the next several years. In particular, the Company's business plan depends on stabilizing and increasing revenue while containing its costs and expenses. The Company believes that the costs involved with the failed Peter Putter lines are behind it and that the future looks bright once again.

DISTRESSED COMPANY VALUATION AND APPLICATION TO RUFFCO GOLF

Often, the investment banker will prepare an informal valuation analysis to indicate possible outcomes from the M&A process and establish reasonable expectations for interested parties. The valuation of distressed companies requires a combination of subjective and analytical modifications to traditional valuation methodologies. In many cases, for example, a company may have deficit EBITDA during the trailing 12-month period, making a simple capitalization of operating cash flow inappropriate.

While a complete review of distressed company valuation is beyond the scope of this case study, the following content highlights the subject.

Market Approach

An analysis of comparable publicly traded companies may provide a benchmark for valuing a firm. Specifically, one can determine a public company's Enterprise Value by adding the company's market value of equity to the value of its net interest-bearing debt (i.e., debt less cash). Then, such Enterprise Value can be divided by a number of relevant measures of financial performance (e.g., revenues, EBITDA, EBIT, etc.) to derive valuation multiples. The derived valuation multiples can then be applied to representative levels of financial performance for a subject company to determine value. The key is to select appropriate multiples and representative indications of financial performance. In the selection of appropriate market multiples one must evaluate the multiples of comparable public companies and M&A transactions taking into consideration the specific risk characteristics of the subject company. Risk factors are, of course, greater with companies undergoing the kinds of distress being experienced by RuffCo Golf. Accordingly, multiples from the low end of the range will be selected.

In the determination of representative levels of revenues, earnings and cash flow, historical levels must often be adjusted to reflect previous mismanagement and any turnaround associated with relief from the company's financial problems. As briefly discussed above, such adjustments may include modifications and add-backs for non-recurring restructuring fees and costs, extraordinary salary/bonuses (private companies), elimination of above-market leases, availability of vendor discounts in the absence of financial distress, more efficient operations unburdened by liquidity constraints, and possible SG&A and regulatory/compliance savings from potential merger synergies. Moreover, in many distressed companies, management (or a buyer) projects a transition (or a turnaround) period before the company stabilizes and reaches appropriate representative levels. In such situations, the appropriate representative levels of financial performance may reflect performance in a future period. Future period representative levels should be discounted back to present at a rate appropriate for the uncertainty of the turnaround. In situations with deficit operating cash flows, useful representative levels of financial performance may also include revenues or averages of past years' earnings, to the extent realistic.

Working Capital Adjustments

Market-based approaches typically assume a "normalized" level of working capital, as the multiples themselves are generally derived from healthy public companies with adequate working capital. In distressed companies, however, working capital positions are often substantially impaired because of liquidity problems. Such illiquidity can result in one or more of the following distortions to working capital accounts:

- Questionable receivables (potentially stemming from poor service, delivery and/or product quality)
- Bloated, obsolete, overvalued, or insufficient inventories
- Stretched or reduced payables

In analyzing a distressed company, careful consideration must be given to the cash-flow impacts of such irregularities, as the return to a normal working capital position can either generate or consume cash, which, in turn, affects value. For example, a return to a normal number of days payable can mean paying off past-due balances (a significant cash use). Likewise, insufficient usable inventories or inadequate collectable accounts receivable could also use cash as the company rebuilds inventory and sales. On the other hand, return of trade credit can provide cash.

In the case of an asset sale (like those pursuant to Section 363 of the Bankruptcy Code), the buyer has the ability to choose not to assume typical operating liabilities such as trade accounts payable. Under Section 363, for example, a debtor with Court approval may sell assets free and clear of all liens, claims and encumbrances (which attach only to the proceeds of such sales). In such cases, the debtor's estate, and not the buyer as in the case of a sale of the common stock of the seller, will have the burden of satisfying obligations to creditors incurred through the close of the asset sale. By not assuming such pre-close operating liabilities as part of the asset purchase structure, the buyer has effectively created excess working capital (current assets less current liabilities). The buyer will then benefit from the resumption of trade credit to the newly deleveraged business, with its improved credit rating. This post-sale transition, financed by newly available trade credit, will turn excess working capital to cash, which may be reinvested in the business, used to reduce debt or (financing covenants permitting) be withdrawn from the business. In an asset acquisition, the additional value of impairing such current liabilities (less the disruption caused by any vendor dissatisfaction) is represented by the present value of the net cash generated by a resumption of trade credit and should be added to the multiples-based valuation.

Deferred Capital Expenditures

In addition to potential working capital adjustments, market-based valuations may also need to be adjusted for deferred capital expenditures. In certain situations, as a company becomes distressed, near-term liquidity constraints result in under-investment in necessary capital expenditures which contribute to long-term value. In other cases, it is the deferral of capital expenditures itself that causes the distress. Either way, a market approach valuation needs to be adjusted for deferred capital expenditures that are necessary to normalize the business in the long run.

In RuffCo Golf's case, the Company did not defer its capital expenditures, and the market valuation approach does not need to be adjusted for deferred capital expenditures.

RuffCo Golf Valuation – Market Approach

Houlihan Lokey has recast historical results to obtain normalized levels of financial performance. The rationale behind recasting historical results, and RuffCo Golf's adjusted historical performance, is set forth in the prior section. By recasting cost of goods sold, nonrecurring professional fees, extraordinary marketing and public relations costs (all of which can be corrected immediately post-acquisition), RuffCo Golf's 2009 and 2010 EBITDA figures were normalized to $19.4 million and $14.2 million, respectively.

Table 14

REPRESENTATIVE LEVEL FINANCIAL PERFORMANCE *($ in Millions)*

	Representative Level		
Recast 2010 EBITDA	$14.2		
Forecast FY 2012 EBITDA	$20.0		
	Discount Rate Range		
	20.0%	–	16.0%
Present Value FY 2012 EBITDA	$13.9		$14.9

Looking forward, Houlihan Lokey determines that the representative levels of financial performance are achieved in the year 2012, which is the year when the Company's operating performance stabilizes. The Company's $20 million EBITDA forecast is discounted back to present value at discount rates that are determined by using the industry weighted average cost of capital (WACC) adjusted for Company-specific risks (please refer to the Discounted Cash-Flow Approach for more detail).

Both historical and forecasted approaches indicate a representative level of EBITDA in the $14 million range. Appropriate market multiples can be applied to these indications of representative EBITDA to derive a range of value.

In the public company arena, however, the difficulties of the prior two years had resulted, by the end of 2010, in Callaway Golf Co. and Adams Golf, Inc. as being the only free-standing U.S. golf equipment manufacturers remaining as potentially suitable comparative public companies to RuffCo Golf. Callaway, however, was severely bruised and took significant losses in 2009 and 2010. Adams took a significant loss in 2009, but was able to get back to nominal profitability in 2010. Each of these survivors shared one characteristic that had contributed to its survival: an almost debt-free capital structure. Callaway's size and only nominal EBTIDA rendered it ineligible as a comparative company to RuffCo Golf. Adams, much closer in size to RuffCo Golf, had successfully navigated the ravages of the recession, retained a relatively healthy balance sheet, and managed to attain an EV/EBITDA ratio of 7x as of the end of 2010. Through good management and lack of leverage, Adams had managed to survive and emerge from the financial crisis with few of the internal problems currently plaguing RuffCo Golf. Adams

represented a kind of "high water mark" of what RuffCo Golf could become if successfully turned-around.

Notwithstanding this dearth of public company comparables, Houlihan Lokey, through its broad range of industry contacts, is able to access a number of recent private M&A transactions involving targets comparable to RuffCo Golf. These private M&A transactions, together with the "high water mark" reflected in Adam's public EBITDA multiple, reflect the golf industry's doldrums described earlier. Houlihan Lokey's analysis of the foregoing results in selected EBITDA multiple ranges for the Company of 3.5 to 5.0. While one might argue that this multiple range is atypically broad, Houlihan Lokey believes it is appropriate given the low multiples exhibited by the industry and the poor performance of the comparable companies. While this range might appear low relative to typical multiple range standards, it is supported by the "comps" because of the industry's manifest problems.

Based on the foregoing analysis of representative levels of financial performance and selected multiples, Houlihan Lokey determines that RuffCo Golf's preliminary market-based valuation falls within a range of $49.2 million to $72.8 million before working capital and other adjustments, as shown in table 15.

Table 15

PRELIMINARY MARKET MULTIPLES VALUATION ANALYSIS

($ in Millions)

	Representative Levels	Selected Multiple Range /Discount Rate			Indicative Valuation Low		Indicative Valuation High
Recast 2010 EBITDA	$14.2	3.5	–	5.0	$49.7	–	$71.0
Forecast FY 2012 EBITDA	$20.0	3.5	–	5.0	$48.7	–	$74.5
		20.0%	–	16.0%			
Preliminary Valuation Range					$49.2	–	$72.8

An analysis of RuffCo Golf's working capital accounts reveals that, while the post write-down accounts receivable and inventory levels are appropriate for RuffCo Golf's business in light of industry standards, the accounts payable and accrued expense accounts have significant inaccuracies, resulting in valuation deductions, as reflected in table 16.

Table 16

WORKING CAPITAL ADJUSTMENTS TO VALUE *($ in Millions)*

	Normal	Current	Adjustment
Accounts Receivable	n/a	n/a	n/a*
Inventory	n/a	n/a	n/a*
Accounts Payable	6.6	16.2	(9.6)
Accrued Expenses	4.6	7.8	(3.2)

** Accounts Receivable and Inventory levels are consistent with industry standards. Accounts Receivable are collected in 50 days and the Company's inventory levels are consistent with turns of 8 times.*

On the other hand, if the buyer were to acquire the assets of RuffCo Golf without any current liabilities, the resulting "excess" working capital position would generate cash inflows as the buyer reestablishes trade credit. As such, table 17 illustrates the appropriate adjustment to RuffCo Golf's value from reestablishing trade credit where liabilities are not assumed.

Table 17

ASSET PURCHASE ADJUSTMENTS TO VALUE *($ in Millions)*

Normalized A/P	$6.6*	Month					
Resumption Schedule of		1	2	3	4	5	6
Incremental A/P		1.10	1.10	1.10	1.10	1.10	1.10
NPV @ 16%	$6.30						

** Based on 2011 forecast purchases and industry standard 45 days payable.*

As illustrated in table 18, the adjusted valuation range shows that RuffCo Golf's Market Approach mean valuation conclusion of $61 million is reduced to $48.2 million where current liabilities are assumed and increased to $67.3 million for an asset-only acquisition.

Table 18

MARKET APPROACH VALUATION *($ in Millions)*

	Current Liabilities Assumed	Assets Only
Average Enterprise Value Conclusion	$61.0	$61.0
Working Capital Adjustments		
- Accounts Receivable [1]	n/a	n/a
- Inventory [1]	n/a	n/a
- Accounts Payable	(9.6)	6.3
- Accrued Expenses	(3.2)	-
Deferred Capital Expenditures [2]	n/a	n/a
Adjusted Market Valuation	$48.2	$67.3

[1] Accounts Receivable and Inventory were normalized during 2000.
[2] Deferred Capital Expenditures are not applicable to RuffCo Golf.

Discounted Cash Flow Approach

Using a firm's projected debt-free cash flow, a Discounted Cash-Flow Approach discounts the projected cash flows from future years back to the present day to determine net present value. To develop such cash flows for a distressed company, a financial advisor will:

- Develop financial projections embodying the projected turnaround, including the impact of interim operating losses. Such forecasts will be projected over a sufficient time horizon to reflect a "stabilized" business with long-term sustainable growth prospects.
- Analyze cash flows on a debt-free basis to avoid distortions created by leverage in the capital structure. Debt-free cash flow is calculated by adding depreciation and amortization to pretax operating income, and then subtracting capital expenditures, changes in working capital and the appropriate deleveraged tax expense.
- Determine a terminal value for the company by using a terminal multiple or terminal growth model approach.
- Determine an appropriate discount rate based on the WACC by using a combination of industry standards and company-specific issues, and applying appropriate return premiums to industry norms to reflect risks inherent in a turnaround scenario.

Caution must be used when using the Discounted Cash-Flow Approach because (i) it relies on projections that are frequently subjective and (ii) the terminal value generally will constitute a majority of the ultimate valuation. The impact of terminal value on the ultimate valuation is especially relevant in distressed situations where the first few years represent the turnaround period during which the company initially achieves negative (or depressed) cash flow. Typically, Houlihan Lokey will perform a sensitivity analysis in order to gauge the effects of achieving or missing projections (such an analysis is beyond the scope of this case study).

RuffCo Golf Valuation – Discounted Cash-Flow

As illustrated in table 19, applying the Discounted Cash-Flow Approach to management's projections yields a valuation of $53.6 million, where current liabilities are assumed, and $72.7 million for an asset-only transaction.

Table 19

DISCOUNTED CASH-FLOW APPROACH VALUATION *($ in Millions)*

	Projections For Year Ended December 31				
	2012 E	2013 E	2014 E	2015 E	2016 E
EBITDA	$15.6	$20.0	$21.8	$22.4	$23.0
Changes in W/C [1]	(23.8)	(1.2)	(0.6)	(0.8)	(0.8)
Capital Expenditures	(4.0)	(4.4)	(4.6)	(4.6)	(4.6)
Taxes @ 40%	(3.0)	(4.6)	(5.8)	(6.4)	(7.4)
Debt-free cash flows	($15.2)	$9.8	$10.8	$10.6	$10.2

WACC Analysis

	Low	High
Industry WACC	13.0%	15.0%
Adjusted RuffCo Golf WACC [2]	16.0%	20.0%

Valuation

Discount	Terminal EBITDA Multiple [3] 3.50	4.00	4.50	5.00
16.0%	$50.1	$55.6	$61.1	$66.6
17.0%	$47.9	$53.2	$58.4	$63.7
18.0%	$45.8	$50.9	$55.9	$60.9
19.0%	$43.8	$48.7	$53.5	$58.3
20.0%	$42.0	$46.6	$51.2	$55.8

				Selected Valuation
Preliminary Valuation Range (Current Liabilities Assumed)	$48.7	-	$58.4	$53.6
Adjustments for an asset-only transaction [4]				
• Accounts Payable	15.9		15.9	
• Accrued Expenses	3.2		3.2	
Adjusted Valuation Range (Assets Only)	$67.8	-	$77.5	$72.7

(1) Assumes current liabilities are assumed and are paid down to normalize working capital position, which was substantial cash in the first year.

(2) After restructuring premiums for financial and operating distress, among others.

(3) Simple terminal value scenario. Others use Gordon Growth Method to illustrate the impact of growth and discount rates on Terminal Value

(4) See "Market Approach" section for calculation. Accounts payable are adjusted to reflect normalized levels and the net present value of reestablished trade debt.

Industry-Specific Benchmarks

In certain industries, rules of thumb may also provide a reasonable indication of value based on a multiple of a specific benchmark. Industry benchmarks include:

- Nursing Homes: Number of beds
- Natural Resource-Related: Quantity of reserves (or other physical measurement)
- Commodity Processor (e.g., steel, pulp, livestock): Production capacity
- Telecommunications: Assets and/or subscriber base

While this approach is inapplicable to RuffCo Golf's industry, it is included here for completeness. Industry-specific benchmarks are particularly valuable in consolidating industries where acquirers can leverage their infrastructure by accruing revenue drivers (e.g., buying beds or subscribers).

Liquidation Value

In a worst-case, meltdown scenario, a company may be worth more dead than alive. In all cases, a distressed company must evaluate its value in liquidation, since this exercise establishes the downside against which all offers must be evaluated. Indeed, Section 1129(a)(7) of the Bankruptcy Code establishes that a Court may confirm a Chapter 11 plan of reorganization without the unanimous consent of all classes of creditors only if holders in impaired classes receive no less than such holders would receive under a liquidation under Chapter 7.

RuffCo Golf Valuation – Liquidation

Liquidation analysis of RuffCo Golf shows the following value:

Table 20

LIQUIDATION APPROACH VALUATION *($ in Millions)*

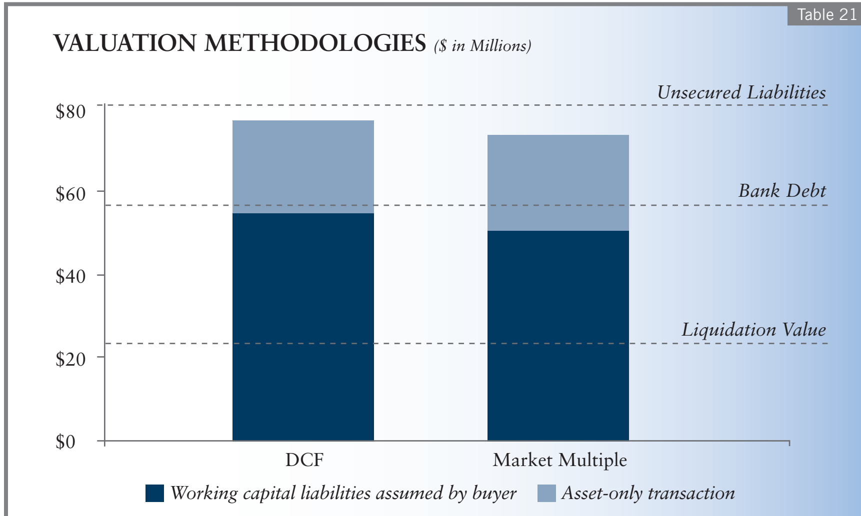
Liquidation	Amount	Assumed Recovery	Value
Accounts Receivable	$10.9	80.0%	$8.7
Inventory			
– Raw Materials	4.8	60.0%	2.9
– Finished Goods	6.0	40.0%	2.4
PP&E			
– Land & Buildings	12.4	80.0%	10.0 [1]
– Equipment	25.8	15.0%	3.8 [1]
Leases	?	-	?
Intellectual Property	?	-	?
Total Before Expenses	$59.9	46.4%	$27.8

[1] *Appraised value.*

RuffCo Golf Valuation

To summarize, Houlihan Lokey's preliminary going-concern valuation of RuffCo Golf yields the following values:

- On an asset-only basis (likely using a Section 363 asset sale), but without the assumption by the buyer of current liabilities, the value of RuffCo Golf is determined to be approximately $70 million.
- On a current liabilities assumed basis, the value of RuffCo Golf is determined to be approximately $51 million.



Houlihan Lokey explains to the Ruffs that such numbers do not contemplate the potential premium pricing associated with an acquisition by a strategic buyer. In such case, RuffCo Golf will attempt to negotiate for a portion of the competitive synergies resulting from such a combination. Houlihan Lokey explains that although there is a reasonable chance of obtaining a superior price, even under the most optimistic scenarios, since the Bank is owed $54.8 million and unsecured creditors are owed $24.2 million, equity holders will likely be left with little or nothing after the debt holders are paid.

Moreover, Houlihan Lokey explains that the Bank may not support any sale transaction that leaves it impaired (i.e., not paid in full), while providing value to unsecured creditors.

Note on Real Estate Leases and Retail Businesses

For a number of reasons, many transactions involving the sale of distressed retail businesses are consummated in Chapter 11 proceedings. One important reason is the debtor's power under Section 365 of the Bankruptcy Code to assume, reject and/or assign unexpired real estate leases and other "executory" contracts.

While the ability to assign a lease to another party is not exclusive to Chapter 11, Bankruptcy Code Section 365(f) generally allows a debtor in Chapter 11 to assume and assign its leases to financially qualified parties, despite lease provisions to the contrary, and even over the objection of the lessor, so long as adequate assurance of future performance is provided by the assignee (and certain other requirements are met, depending on the nature of the lease). Retail businesses and restaurants in particular, as well as other real-estate intensive businesses like movie theaters, can benefit from this power, as a sale can be structured to permit an acquirer to obtain attractive leases to desired locations, leave unattractive leases or undesirable locations behind, and/or eliminate duplicative locations. All of this, as described below, can create additional value for the assets of the distressed seller. Whether in Chapter 11 or not, the value of a real estate-intensive business may be maximized through the sale of the leasehold interests. Often, such value is indicated by a multiple of the four-wall (or individual store level) cash flow without the burden of corporate overhead. Where four-wall cash flow is positive and therefore exceeds operating cash flow after corporate overhead, a prospective buyer should be willing to pay for a portion of the synergy.

Under Section 502(b)(6) of the Bankruptcy Code, when leases are rejected, any resulting rejection claims become general unsecured claims of the estate (and subject to the limitations therein), rather than the responsibility of the buyer of the other assets. As such, a prospective buyer is able to acquire selected assets (e.g., favorable leases and contracts) without having to assume burdensome leases and contracts, which negatively impact value. Because a buyer can leave the estate with burdensome leases and contracts that would otherwise reduce value, a prospective buyer can pay a higher price for the selected desired assets. However, given that the pool of unsecured claims will increase if leases/contracts are rejected, any increased consideration will have to be evaluated by the debtor and its creditors in light of the increase in unsecured claims and the potential dilution of unsecured creditor recoveries.

THE TROUBLED COMPANY SALE PROCESS

As part of the discussion with the Board and management about Houlihan Lokey's preliminary, confidential valuation of the Company, Houlihan Lokey details the potential transaction structures and process for a sale of RuffCo Golf and explains RuffCo Golf's integral role.

Transaction Structure

Table 22 shows several different structures which may be used in the sale of a troubled company. Each is discussed by Houlihan Lokey with the Board and with management. A detailed description of each is beyond the scope of this case study. However, in the situation faced by RuffCo Golf, including, among other things, the likelihood that the value of the Company is less than its liabilities, Houlihan Lokey recommends, and the Board and management agree, pursuing a conventional asset sale, to be consummated, if necessary, in a Chapter 11 pursuant to Section 363 of the Bankruptcy Code.

Table 22

DISTRESSED M&A TRANSACTION STRUCTURES

Conventional stock/asset purchase
Friendly foreclosure
Assignment for the benefit of creditors
Section 363 sale
Chapter 11 plan of reorganization acquisition
Chapter 7 Trustee liquidation sale

Preparation

Houlihan Lokey will work with the Company on several fronts to agree on a sale process and strategy and prepare the Company for market.

The Story: Houlihan Lokey will work with the Company to determine the appropriate "story" to discuss with potential buyers. The story will articulate the causes for the Company's past and current difficulties, quantify their impact on the Company, and illustrate for potential buyers how the post-acquisition, deleveraged Company might be turned-around and re-generate the growth and financial success RuffCo Golf had enjoyed in prior years. Generally, the story will be tailored to each buyer.

Buyer Universe: Following its initial due diligence, Houlihan Lokey will identify the universe of potential buyers, making sure to incorporate the views of management, which will know many of the potential strategic buyers. In addition to strategic buyers, Houlihan Lokey will determine whether the situation is appropriate for a financial buyer.

- Strategic Buyers, typically competitors or companies in similar businesses, may look to purchase the Company for its product lines or assets, and seek to exploit the synergies (e.g., eliminating duplicative costs) associated with an acquisition.
- Financial Buyers, also known as private equity investors, typically purchase a company as a stand-alone going concern. As such, the Company must have a viable stand-alone business plan that indicates a strong equity return. Financial players are particularly interested in growth scenarios and may find a company more attractive if it is a "platform vehicle" upon which it can layer additional acquisitions in the industry. A financial buyer may also seek to acquire a company as an add on to one of its existing portfolio companies, effectively acting as a strategic buyer.

The scope, or breadth, of the sale process is also important. The Company and Houlihan Lokey must assess the advantages and disadvantages of limiting the bidder universe to a strategic short list, or going to market broadly. In assessing the foregoing, Houlihan Lokey will evaluate whether there are relatively few, easily identified potential purchasers (typically strategic players) and whether there is, in addition, a broad, but more difficult to identify, group of prospective buyers (often financial buyers) with the appropriate appetite for the deal.

In certain situations, one potential purchaser might be far ahead of the field and may want to immediately perform due diligence to work toward delivering a letter of intent under an expedited time frame. In such a case, the Company and Houlihan Lokey would weigh the benefits of encouraging a fast offer (timeliness) versus creating the appearance that one party has a lock on the deal, thereby discouraging other (and potentially higher) offers.

<u>Timing</u>: In distressed transactions timing is generally critical. Constrained liquidity creates the risk that the company could run out of cash. Relationships with vendors are fragile and deteriorating. The passage of time can result in key employee departures in the face of fear and uncertainty. Revenues continue to decline as customers begin to migrate as a result of anxiety about delivery, quality and service. Each of these factors feeds on the other. As a result, Houlihan Lokey will need to get to market as soon as possible. That said, the Company and Houlihan Lokey will want to avoid the (often inevitable) appearance of desperation. On the other hand, the failure to consummate a timely transaction could be terminal for a financially distressed going concern. As part of its due diligence, Houlihan Lokey will work with the Company, and often with its lender, to assess the remaining liquidity (i.e., the time by which a transaction absolutely must be consummated in light of projected cash depletion, lender fatigue, or both). Then, working back from a "drop-dead date," Houlihan Lokey can establish process parameters, including:

- Whether sufficient time remains to prepare a full-blown Offering Memorandum, or whether Houlihan Lokey and the Company should rely on a "Teaser" (or summary) Memorandum, together with supplemental materials and on-site visits by prospective buyers.

- Whether time permits the process to unfold prior to establishing a bid date, or underlying circumstances require the establishment of an early bid deadline to permit a transaction closing by the "drop-dead date" (and perhaps to provide the evidence of value necessary to persuade the lender to continue financing through closing).
- Whether time permits a two-step bidding process, whereby bidders are encouraged to submit initial indications of interest before "qualifying" to visit the Company and perform on-site due diligence with management, whose time is being consumed by daily emergencies, or whether the imminence of the "drop-dead date" requires that the Company submit to immediate comprehensive due diligence by all interested parties.

While Houlihan Lokey can rush a distressed company to market and close a sale transaction in as few as 30 to 45 days, value will generally be enhanced through an aggressive but less frenetic sale process, provided, of course, there is adequate liquidity.

Initial Due Diligence and Data Room: Based on its own initial due diligence request list submitted to the Company at the commencement of their engagement, Houlihan Lokey will begin to compile a carefully indexed data room with all relevant information that a buyer might require for its due diligence on the Company. A data room may include detailed documentation regarding financial information, products and markets, legal matters, real property, personal property, insurance coverage, human resources, MIS operations, inter-company agreements and public relations, among others.

Teaser Memorandum: Houlihan Lokey will prepare a "Teaser" Memorandum to be sent to the potential investor universe, summarizing the investment opportunity. While the teaser offers an optimistic, sales-oriented spin on the Company's financial distress, it should provide a realistic discussion of the Company's problems to establish credibility, avoid misperceptions and wasting all parties' time.

Confidential Memorandum: Time permitting, Houlihan Lokey will also prepare an Offering Memorandum setting forth a detailed overview and analysis of the Company's historical operations and financial performance, business plan and projections, and investment considerations.

- In contrast to a healthy company's Offering Memorandum, a distressed company's Offering Memorandum will often seek to de-emphasize the Company's liabilities, unless equity has a legitimate claim to value in excess of the debt. In truly distressed transactions, Houlihan Lokey will seek to encourage potential buyers to value the going concern and assets, and not be intimidated by the level of liabilities, which often exceed any reasonable estimate of Enterprise Value. In Chapter 11, such liabilities may be left behind to be dealt with by the bankruptcy estate, leaving the buyer with a deleveraged business capable of rebuilding trade credit, as described earlier.

- The Offering Memorandum likely will feature a detailed presentation of the assets of the Company, which could, although this is not preferable, be sold piecemeal to interested investors (probably strategic buyers) to help maximize value. Such assets could include intellectual property (patents, trade names, copyrights), leases (which, as discussed above, are subject to special provisions under the Bankruptcy Code), current assets (including accounts receivable and inventory), and property, plant and equipment.
- Although some buyers may be interested only in certain assets, the Offering Memorandum distributed to all potential purchasers will clearly set forth a detailed Business Plan including a (hopefully) persuasive description of the story articulating the going-concern value. Even if it fails to attract financial buyers, the Offering Memorandum will seek to keep the strategic vultures "honest" in their value assessments.

Public Relations Strategy: In certain circumstances, the Company will want to disclose publicly its retention of Houlihan Lokey to "explore strategic alternatives". While the potential adverse publicity surrounding such a release (e.g., impact on customer base and vendor relationships) should always be evaluated, such disclosure could trigger the interest of a potential purchaser that has failed to make the Buyers List.

Before Houlihan Lokey can broadly market a transaction for a company with public debt and/or equity, such company should consult with counsel to determine whether it is required to disclose Houlihan Lokey's involvement to the public and/or through filings with the SEC.

Contact and Discussion

Houlihan Lokey will control the process and provide a focused contact point for potential purchasers. Such control allows the Company to maintain a consistent story for potential bidders and leverages the time of management.

Confidentiality: Houlihan Lokey will require all parties expressing a further interest to execute a confidentiality agreement in order to limit the universe of interested parties to those with real interest and protect the confidentiality of non-public and other more sensitive information. The Company will, of course, be extremely sensitive to providing competitors, customers and suppliers with candid information illustrating the Company's problems. Some such parties may simply be trying to gain an informational advantage, which might be used to harm the Company's going-concern value. Houlihan Lokey will work with the Company to attempt to strike a practical balance between the need to share sensitive information with prospective purchasers and the desire to prevent unprincipled constituents from obtaining the Company's secrets. Recognizing the need to move quickly, however, Houlihan Lokey must avoid letting the process get bogged down in fights between the lawyers.

Process and Bid Dates: Depending on (i) current liquidity, (ii) the attractiveness of the Company and (iii) management's available time and resources, Houlihan Lokey and the Company will evaluate whether to require initial indications of interest prior to permitting on-site visits with management. In many distressed situations, however, the Company's lack of liquidity will dictate getting as many parties in to visit management as quickly as practicable. In such cases, the goal may be to identify as quickly as possible a real buyer offering a reasonable price, who is prepared to consummate a transaction immediately without material contingencies.

In practice, Houlihan Lokey will generally need to establish a bid date to encourage interested parties to submit their offers, as few parties desire to move preemptively for fear of becoming a "stalking horse"—a buyer whose early offer is shopped to other potential buyers to provide a valuation baseline and drum up interest.

Follow-Up, Follow-Up, Follow-Up: Houlihan Lokey will maintain contact with all potential purchasers (and follow leads to new parties) in order to develop their interest and encourage their investigation and investment.

Buyer Education on Structure and Process: When acquiring distressed companies, buyers (especially strategic buyers) often are entering unfamiliar territory. In order to assuage their concerns and familiarize them with the process, Houlihan Lokey must often educate the buyers on the more esoteric aspects of distressed company valuation where applicable and, if necessary, assist interested parties with the preparation and structure of an acceptable offer. At the appropriate time, Houlihan Lokey may suggest the retention of knowledgeable professionals (e.g., bankruptcy counsel) to help the buyers.

Lender Communication: Throughout the process, Houlihan Lokey and the Company will maintain clear lines of communication with the lenders. The lenders' participation may enable the Company to maintain continuous liquidity during the process (both in- and out-of-court) and may ultimately be essential to closing the deal.

Financial Screening: Throughout the process, Houlihan Lokey will screen potential investors for financial bona fides to avoid wasting management's time. This will likely be an expedited process because of the extent of Houlihan Lokey's relationships with many of the most active (likely) buyers. The following characteristics are typical of a credible buyer:

- Ability to provide cash (i.e., demonstrated sources of financing) or other acceptable consideration
- Experience in buying companies (healthy or distressed)
- References or prior working relationships
- Experience in industry
- Ability to close quickly
- Extensive and focused due diligence
- Early utilization of sophisticated counsel

Management Presentation: Houlihan Lokey will prepare a Management Presentation and stage a run-through with the Company before buyers begin their visits. Potential purchasers' styles will vary from focusing almost exclusively on the information contained in the data room to spending more time asking hard questions of management.

Note on Management Retention and Involvement: This is a difficult time for management personnel, many of whom are wondering if they will have a job at the end of the process. At or prior to this point, the Company will want to consider retention bonuses for key employees to keep the business running during the sale process. Houlihan Lokey will provide the Board with input regarding standards for retention plans. Moreover, conflicts can potentially arise if, as sometimes happens, one potential buyer seeks to "tie up" key employees as a preemptive strike at obtaining the Company. Houlihan Lokey will work with the Company to maintain a level playing field.

Bid Procedures

Where appropriate, Houlihan Lokey will establish Bid Procedures to be followed by all interested parties. In addition to deadlines, such procedures should require purchasers to provide the following information:

- Description of the purchaser, as well as its industry and transaction experience
- Sources of funding, with contact names to verify availability and adequacy
- Material conditions, representations and warranties
- Transaction structure – stock or assets; liabilities to be assumed
- Consideration offered (cash, securities, etc.), including any hold-backs or earn-outs (which provide for future payments to the Seller based on the passage of time and/or performance of the business)
- Deposit size and timing

In articulating the Bid Procedures, Houlihan Lokey will clearly express a preference for proposals with few (if any) material contingencies, which can be satisfied quickly. Moreover, while cash is the preferred consideration in distressed situations, Houlihan Lokey will articulate a willingness (but generally not a desire) to consider and evaluate proposals containing non-cash consideration. In the event a buyer chooses to offer common stock or debt securities as part of its proposal, Houlihan Lokey will value such consideration to permit comparison of all offers.

Negotiation and Closing

After receiving initial proposals, Houlihan Lokey will evaluate the bids, clarify any ambiguities and seek (where appropriate) to improve and firm up bids, while maintaining flexibility with respect to the offers put on the table. Houlihan Lokey also will work with the final bidders to determine the sales format that will help maximize recoveries to the seller's stakeholders.

Houlihan Lokey will work with buyers to establish acceptable sales process procedures through which the buyers will clearly articulate the material business terms they are seeking. Specifically, properly advised buyers will typically seek bidding protections in the form of no-shop clauses, overbid procedures and break-up fees. These provisions are briefly described in table 23.

Table 23

SALE PROVISIONS

Terms	Common Usage	Brief Description
No-Shop	Out-of-Court	Company agrees not to continue shopping the Company to other parties
Overbid Procedure	In-Court	Court-approved auction procedure requiring overbidders to exceed existing bid by a set amount
Break-Up Fee	In-Court or Out-of-Court	Negotiated fee to be paid to buyer in the event another party buys the Company for a higher level of consideration. Must be court-approved in Chapter 11.

Unless proscribed by a no-shop provision, Houlihan Lokey will continue to work with other bidders until the last possible moment in order to keep them informed of the process and to possibly revive them as a backstop if the winning bidder does not close. Once a final bidder and format is selected, time is of the essence.

- Houlihan Lokey typically will negotiate a material (between 5% and 20%) nonrefundable deposit.
- Houlihan Lokey will work with the Company's legal advisors who are drafting the Purchase Agreement to balance the risk of moving too fast (resulting in sloppy drafting, missed issues) versus the risk of losing the deal or having it retraded by an increasingly worried buyer.

On one hand, the Company's interim liquidity problems may reduce its negotiating leverage with the Buyer. On the other, the Buyer will be interested in getting control of the Company to start fixing problems and reversing the financial deterioration as soon as possible.

Lengthy delays will invariably create issues regarding interim management, purchase price adjustments for items such as inventory and receivables (which are constantly changing), and defining a material adverse change (MAC) clause (which allows the buyer to avoid its commitment to purchase the Company should circumstances change materially). In general, Houlihan Lokey advises its clients against MAC clauses in a distressed M&A transaction since the Company's precarious financial position makes some business deterioration likely in any event, and the Company will need to prevent the Buyer from wiggling out of the transaction, which might result in the business running out of cash before another buyer can be put in place.

After contacting approximately 60 parties by email, phone and fax, and providing them with teaser and confidentiality agreements, 15 bidders sign confidentiality agreements and receive detailed information packets. Eight bidders visit the Company to meet with management and perform due diligence. On the bid date, six bidders submit indications of interest, two of which are dismissed outright as inadequate or non-credible, leaving four final bidders. Of the final four bidders, two are financial buyers and two are strategic buyers. The proposals are illustrated in table 24.

Table 24

INITIAL EXPRESSIONS OF INTEREST

Buyer	Nominal Purchase Price	Current Liabilities Assumed	Relative Financial Strength	Contingencies to Closing: Due Diligence	Contingencies to Closing: Financing	Closing Timing	Format
Financial							
Midas Partners	$50 MM	None	Highest	Some DD required	No	5 wks.	363 Asset Sales, Chapter 11 required
Elusive Ventures	$52 MM	None	Uncertain	Substantial DD required	Yes	"Will work around the clock to close soon"	Unclear
Strategic							
Augusta, Inc.	$30 MM	$24 MM	Medium	Limited DD required	No	3 to 6 wks.	Flexible, but wants to both buy assets and assume trade
Cypress Corp.	$34 MM	$24 MM	High	Will complete in "3 business days"	Yes	3 to 6 wks.	Needs to discuss with advisors, but is clear about desire to avoid Chapter 11

As expected for a company with this level of financial distress, all the parties express an interest in an asset sale transaction. Because of their relationships with the suppliers in the industry, the strategic investors are interested in assuming trade debt. Midas Partners, as a financial investor, seeks Son's expertise, and Augusta, a competitor, requires a non-compete from both Father and Son.

Keeping in mind the Company's financial deterioration and creditor pressure, Houlihan Lokey immediately seeks to sort out the different bids to determine the value of each proposal and its likelihood of closing. Since a distressed company often lacks the privilege of turning away low bidders (unless they fall below liquidation value), a primary source of negotiating leverage in a distressed situation is the presence of multiple bidders.

Based on numerous telephone conferences, in-person meetings, confidential discussions and negotiations, final bids are delivered to Houlihan Lokey. Houlihan Lokey's assessments of the bids are delineated in table 25. Since some of the proposals include non-cash consideration, Houlihan Lokey values the non-cash consideration in order to compare the proposals.

Table 25

FINAL BIDS

Buyer	Nominal Purchase Price			HL Valuation of Bid	Deposit	Treatment of Lease	Contingencies to Closing			Format	Lawyer Hired
	Cash	Other	Liabilities				Due Diligence	Financing	Other		
Financial											
Midas Partners	$52 MM	None	No	$52 MM	$3 MM	Assume through bankruptcy sale	Final DD required	No	MAC clause	363 Asset sale, Chapter 11 required	Yes
Elusive Ventures	$8 MM	$20 MM liquidation preference of public preferred stock and $32 MM 5-year 12% interest-only note from principal	No	$39 MM [1]	None	Willing to buy facility from Father by issuing municipal bonds	Final DD required	Yes	None	Asset purchase out-of-court	No
Strategic											
Augusta Inc.	$32 MM	$4 MM holdback for purchase price adjustment	Yes	$30 MM [2] to secured creditor and $24 MM to unsecured	$2 MM (with lawyer OK)	Deal subject to renegotiating long-term lease	"One more week" of DD required	No	Renegotiated lease; 3-year non-compete	In- or out-of-court asset purchase, wants to assume trade	Yes, if deal accepted
Cypress Corp.	$60 MM	Won't assume trade debt	No	$60 MM	$1.5 MM	Will not assume lease but requires 1-year lease at current rates	None	"3 days after deal is done, we'll have the bank wire the money"	None	Asset purchase out-of-court	Yes, but still insists on out-of-court deal

[1] Preferred stock tracks at $12.50 per share (Liquidation preference: $25 per share), note discounted at 25% capitalization rate to reflect risk.
[2] HL valuation after adjustment for risk of holdback.

Buyer Selection and Negotiation Strategy

Houlihan Lokey meets with the Board, including Father and Son, and the Bank to discuss the Company's options. The Bank does not support any deal that does not pay it off in full. In particular, the Bank is concerned about the Augusta proposal, which assumes trade debt but does not repay the Bank in full. After the meeting, the Company (with the Bank's blessing) decides to offer Cypress the deal on the following conditions:

- **Price:** $64 million cash at closing for the assets only. Price will be subject to adjustment through working capital formula applied at closing.
- **Lease:** Assumed for two-year period at slightly reduced rate, during which time "good faith" negotiations will be held to buy or lease the facility from Father on a long-term basis.
- **Contingency:** Financing contingency to be eliminated within three days (prior to documentation efforts).
- **Deposit:** $4 million in cash, which shall be nonrefundable unless the Company fails to deliver (or the Court in Chapter 11 does not approve) the deal.
- **Chapter 11:** All parties agree to attempt to effectuate an out-of-court deal. However, if impediments arise, the deal will be consummated through a Chapter 11 Section 363 asset sale. Of course, Houlihan Lokey and Counsel will continue to educate the buyer on typical concerns regarding out-of-court asset sale deals by an insolvent company (including the need to obtain creditor consent and potential future fraudulent conveyance arguments by disgruntled interested parties).
- **Employment of Son:** Two-year employment contract for Son with appropriate title, benefits, salary and bonus opportunities.

If Cypress declines, Houlihan Lokey and the Company are prepared to turn to the other parties (Midas and/or Augusta) and negotiate with them. However, Cypress accepts the deal and obtains its financing commitment the next day. With its financing in place, Cypress' lawyers begin to document the transaction, and now demand the following protections:

- **No-Shop Clause:** The Company must agree not to use Cypress' bid to entice other potential bidders.
- **Break-Up Fee:** $6 million, to be paid in the event that Cypress stands ready to close and the Company consummates a transaction with another party, either in- or out-of-court.
- **Overbid Protection**: In the event that the parties agree that the sale must be made in Chapter 11 pursuant to Section 363, which is subject to public auction and overbidding, Cypress demands that a $10 million initial over bid be required of other bidders.

The Documented Deal

The parties then negotiate the following final terms:

- **Break-Up Fee:** $1.6 million (inclusive of all expenses).
- **Chapter 11 Terms:** In the event that the sale is consummated in Chapter 11 pursuant to Section 363, the parties agree to obtain immediate Court approval of bidding procedures to be adhered to by other prospective purchasers, as well as the Court's approval of the Break-Up Fee and Overbid Protection.
- **Overbid Protection:** $3 million initial overbid, $200,000 minimum incremental bids thereafter.
- **Deposit:** $4 million for competing bidders, which shall become nonrefundable if the bid is accepted and shall be provided 24 hours prior to hearing.
- **Form of Contract:** Asset purchase agreement with limited representations and warranties and essentially no material adverse change provisions.
- **No-Shop Clause:** To the extent permitted under law (i.e., subject to Chapter 11 issues), RuffCo Golf agrees not to continue actively shopping the Company.

Other items discussed and resolved include:

- Taxes
- Environmental issues
- Product liability issues
- Hart/Scott/Rodino filings
- Retiree pension/benefit issues
- Director/management indemnification issues
- Contract/warranty obligations/lease assumption
- Current asset/liability closing adjustments with cash on hand retained by RuffCo Golf

As Father is growing more concerned over his personal guarantees (which could put at risk his non-RuffCo Golf assets) than with a recovery on his equity, he, together with the Board and management, decides to move forward aggressively with the sale. The Company is continuing to bleed cash and wants to close a transaction as soon as possible.

Unsecured Creditor Issues

Until now, the Company has negotiated chiefly with the Bank because of its status as the only secured creditor and its control over the Company's liquidity. At this point, however, it is clear the unsecured creditors are facing significant impairment and the ability to consummate the transaction outside of Chapter 11 will require their involvement. Moreover, several large unsecured creditors have formed an informal committee to explore the options for receiving outstanding payment. At the Company's expense, the committee hires counsel and its own financial advisor.

The Company calls a meeting with its creditors in an attempt to craft an out-of-court composition, or informal plan, which the Company facilitates by hiring a professional trade creditor group. In the written follow-up before the meeting, the Company proposes that the trade creditors agree to a lawsuit moratorium and to continue providing new product on a COD or CIA basis.

At the meeting, the Company makes a presentation to the creditors explaining the financial condition of the Company and an overview of the proposed sale, including the sources and uses statement set forth in table 26.

Table 26

SOURCES AND USES OF FUNDS FROM SALE OF ASSETS *($ in Millions)*

Sources	**Accepted Bid**
Cash Consideration	$64.0
Total	$64.0
Uses	
Pay down Bank debt	$54.8
Pay down DIP	2.0
Professional/administrative fees	3.0
Unsecured creditors	4.2
Total	$64.0

Since unsecured claims (including accrued expenses) total approximately $24.2 million and the amount available for unsecured creditors is equal to $4.2 million, the Company's plan provides a projected unsecured creditor recovery of about 17.4 cents on the dollar. (This analysis assumes a possible $2 million DIP that the Bank has promised to the Company.) Although the creditors are unhappy, many have known that the Company has been in trouble for a long time and are, frankly, pleased to receive anything. Several are pleased that the Company will continue as a going concern and that they will be in a position to do business with Cypress as the new owner. Others, however, are outraged. One such creditor threatens to sue everyone, including the Company's lawyer and financial advisor, and states that "Father should be hung upside down and shaken until my money falls out of his pockets."

Two of the creditors contact the Company. One, a small but critical creditor, sends RuffCo Golf a demand letter for immediate payment. The second, an important vendor, files a suit against the Company for payment of past due amounts. The Bank is unwilling to advance any additional funds outside of Chapter 11.

Chapter 11 Filing and Auction

At this point, given the aggressive actions of several creditors and the decreasing likelihood of obtaining creditor consents and finalizing the sale out-of-court, the Board, management, the Bank and Cypress agree that RuffCo Golf should file for Chapter 11 in order to consummate the asset sale under Section 363 of the Bankruptcy Code, free and clear of all creditor claims. The sale document is finalized during a 16-hour "all-hands" drafting session.

A bankruptcy petition is prepared, as authorized by the Board, and filed, together with a motion requesting the Court to schedule an auction and final sale hearing in 35 and 37 days, respectively. As also required by the agreement with Cypress, the Company files a motion on shortened notice requesting the Court to approve the break-up fee/ bidding procedures at a hearing to be scheduled in five days. The Bank confirms that it will advance an additional $2 million to the Company under a DIP loan.

At the hearing on the motion to approve the break-up fee and bidding procedures, both the creditors' committee lawyer and the U.S. Trustee, who is charged with monitoring Chapter 11 cases as representative of the U.S. Department of Justice, pose limited objections. The lawyer for Elusive Ventures files a detailed objection, claiming it wants to ensure a "level playing field". Midas' lawyer, who also is present,

remains silent. The Court denies all objections and approves the break-up fee and bidding procedures, as well as the dates for the auction and final sale hearing.

With the Company in bankruptcy, and the break-up fee and bidding procedures in place to protect Cypress, Houlihan Lokey and RuffCo Golf are obligated to continue their efforts to increase the price of the transaction by going back to interested parties. Midas and Augusta continue discussions with the Company regarding the bidding process, while others are informed of the deal and the pending auction. On the bid submission date (48 hours before the auction date), Midas and Augusta (acting jointly) submit the required $4 million deposit and their $67 million bid.

At the auction, Elusive Ventures announces that it is prepared to pay $84 million using a complex financing scheme, secured by Mexican and Costa Rican securities, as well as non-cash consideration in the form of common stock in a non-public Internet start-up and requests a 48-hour adjournment to arrange for the $4 million deposit. Although several major public shareholders announce their support for an adjournment and for the Elusive Ventures deal, the Company and Houlihan Lokey (in consultation with the Bank and creditors committee) reject Elusive Ventures' request, saying that it had plenty of notice to come up with the deposit on time.

Houlihan Lokey proceeds to conduct an auction at the Company's lawyers' offices, beginning with Midas/Augusta's $67 million bid; Cypress counters at $67.2 million (specifying that it is credit bidding its break-up fee) and, after several rounds of bidding, Midas/Augusta bids $73 million. After a short recess, Cypress concedes victory to Midas/Augusta. (Although Elusive Ventures' lawyer threatens to sue all the parties involved and objects at the sale hearing, the firm eventually agrees to back off.) The parties appear before the Court two days later at the final sale hearing with a fully executed purchase agreement. The Court enters the proposed order approving the sale. The closing for the transaction is scheduled for 12 days after the sale order is entered, and funds are transferred on that date. The Bank is paid on closing.

Table 27

SOURCES AND USES OF FUNDS FROM SALE OF ASSETS *($ in Millions)*

	Accepted Bid
Sources	
Cash Consideration	$73.0
Total	$73.0
Uses	
Pay down Bank debt	$54.8
Pay down DIP	2.0
Professional/administrative fees	3.0
Break-up fee	1.6
Unsecured creditors	11.6
Total	$73.0

Table 27 above details the transaction sources and uses for the funds generated by a sale of assets under the auction-winning bid. Table 28 illustrates the auction's value-maximizing impact on the unsecured creditors' payout.

During the 90 days thereafter the Company proposes and confirms a plan of reorganization whereby, after Cypress receives its break-up fee, unsecured creditors receive 47.9 cents on the dollar.

Table 28

AUCTION'S EFFECT ON UNSECURED CREDITORS' RECOVERY *($ in Millions)*

	Amount	Recovery
Amount owed	$24.2	n/a
Amount recovered		
Initial bid	$4.2	17.4%
Auction-winning bid	$11.6	47.9%

"Buying and Selling the Troubled Company" is a fictional case study created to provide the reader with an overview of a relatively simple distressed company M&A process from start to finish. We are providing you with this publication with the express understanding that it cannot be reproduced without our written permission, and may not be introduced directly or indirectly in any litigation context in which we may be involved. This publication is not intended to provide legal advice. Recipients of this material and anyone using this material should not rely on anything in this material, but rather should consult their own counsel for legal advice.

© 2011 Houlihan Lokey. All rights reserved. This material may not be reproduced in any format by any means or redistributed without the prior written consent of Houlihan Lokey. Houlihan Lokey is a trade name for Houlihan Lokey, Inc. and its subsidiaries and affiliates which include: Houlihan Lokey Financial Advisors, Inc., a California corporation, a registered investment advisor, which provides investment advisory, fairness opinion, solvency opinion, valuation opinion, restructuring advisory and portfolio management services; Houlihan Lokey Capital, Inc., a California corporation, a registered broker-dealer and SIPC member firm, which provides investment banking, private placement, merger, acquisition and divestiture services; and Houlihan Lokey (Europe) Limited, a company incorporated in England which is authorized and regulated by the U.K. Financial Services Authority and Houlihan Lokey (China) Limited, a company incorporated in Hong Kong SAR which is licensed in Hong Kong by the Securities and Futures Commission, which provide investment banking, restructuring advisory, merger, acquisition and divestiture services, valuation opinion and private placement services and which may direct this communication within the European Economic Area and Hong Kong, respectively, to intended recipients including professional investors, high-net-worth companies or other institutional investors.

Houlihan Lokey

Houlihan Lokey is an international investment bank with expertise in mergers and acquisitions, capital markets, financial restructuring, and valuation. The firm is ranked globally as the No. 1 restructuring advisor, the No. 1 M&A fairness opinion advisor over the past 10 years, and the No. 1 M&A advisor for U.S. transactions under $1 billion, according to Thomson Reuters. Houlihan Lokey has 14 offices and more than 800 employees in the United States, Europe and Asia. The firm serves more than 1,000 clients each year, ranging from closely held companies to Global 500 corporations. For more information, visit www.HL.com.

MERGERS & ACQUISITIONS

CAPITAL MARKETS

FINANCIAL RESTRUCTURING

FINANCIAL ADVISORY SERVICES

HL.com

Distressedmanda.com